APPENDIX.

Facts of Consolidated Cases.

A. BEN

On May 12, 1977, Cal Fed made a loan to finance the purchase of a home in Mission Viejo, California, by James M. McCrary, Sesil O. Adams and Sharon R. Adams ("McCrary/Adams") which was evidenced by a deed of trust securing a promissory note for $52,000.00. The deed of trust contained a due-on-sale provision.

By deed recorded November 20, 1978, McCrary/Adams conveyed the property to John William Ben and Sarah L. Ben ("Bens"). The consent of Cal Fed to this transfer was not obtained and the latter accelerated its loan and demanded full payment.

On December 7, 1978, Cal Fed brought suit in the United States District Court, Central District of California, for declaratory relief and to foreclose its deed of trust. That action was dismissed on February 27, 1979, by the court holding that federal subject-matter jurisdiction could not be obtained by seeking a declaratory judgment establishing federal preemption as a defense or response to a defense in a potential state court action.

Thereafter, Cal Fed resumed the acceleration of its loan and a notice of default was recorded.

The Bens filed suit in state court to enjoin the foreclosure and for other relief. A motion by the Bens for preliminary injunction was denied and serves as the basis for this appeal. The foreclosure was enjoined during this appeal.

B. HANLON

On November 3, 1977, Richard and Marilyn Stenzel ("Stenzels") obtained a loan for $50,500.00 from Cal Fed to finance their purchase of a dwelling in Laguna Hills,

California. To secure the loan the Stenzels executed a promissory note secured by a deed of trust containing a due-on-sale clause.

Without informing Cal Fed or obtaining its consent, Stenzels conveyed the real property to appellants George and Janis Hanlon ("Hanlons") on August 1, 1979.

Cal Fed accelerated the principal balance and demanded full payment based upon the due-on-sale clause. When neither the Stenzels nor the Hanlons paid the balance, Cal Fed commenced foreclosure by causing a notice of default to be recorded.

After filing suit to enjoin foreclosure, the Hanlons were denied a preliminary injunction. Upon taking an appeal from such denial, the Hanlons were granted an injunction against the foreclosure during this appeal.

C. DUNN

On May 4, 1973, Cal Fed made a loan to H. La Verne Smith and Alma P. Smith ("Smiths") for $32,700.00. To secure the loan the Smiths executed a promissory note and deed of trust in favor of Cal Fed. The deed of trust encumbered a dwelling located in Riverside, California. Both the note and deed of trust contained due-on-sale clauses.

On June 18, 1975, the Smiths conveyed the real property to Michael and Diane Dunn ("Dunns"). The conveyance was made without the consent of Cal Fed, which thereafter accelerated the loan by exercising the option contained in the due-on-sale clause and demanded that the loan be paid in full.

After the Smiths failed to pay the accelerated balance, Cal Fed declared a default and the trustee named in the deed of trust recorded a notice of default. Shortly thereafter, Cal Fed filed a complaint to foreclose the deed of trust and for declaratory relief against the Smiths and Dunns.

The Dunns cross-complained against Cal Fed seeking declaratory relief and to enjoin foreclosure.

Cal Fed and the Dunns entered into an Agreement For Stay of Proceedings and Reservation of Rights wherein Cal Fed agreed to refrain from foreclosure while the Dunns agreed to make payments on the Smith loan, the acceptance of which would not constitute a waiver of any rights of Cal Fed under its deed of trust, specifically the right to enforce the due-on-sale clause. The agreement was subject to cancellation by either party, but otherwise would remain in effect until the disposition of *Glendale Federal Savings & Loan Ass'n v. Fox,* 459 F. Supp. 903 (C.D. Cal. 1978), which presented the question of whether pertinent federal regulations preempted conflicting state law concerning the enforcement of due-on-sale provisions in the loan documents of federally chartered savings and loan associations.

On December 20, 1979, the Dunns sought to file an amended complaint and to obtain a preliminary injunction restraining Cal Fed from proceeding with foreclosure under the power of sale in its deed of trust. The request to file an amended complaint was granted, but the preliminary injunction was denied. The Dunns have appealed from such denial.

D. RENNER

A dwelling in Riverside, California, was the security for a loan made by Cal Fed to Gary and Catherine Funk ("Funks"). The Funks executed a deed of trust securing a promissory note for $54,000.00 which was recorded July 22, 1977.

Funks transferred the property to William and Beverly Renner ("Renners") by deed recorded April 30, 1979. Cal Fed did not consent to the transfer and, upon learning of it, demanded that its note be paid in full. The Renners did

not pay the accelerated balance and notice of default was recorded.

The Renners brought an action to enjoin the foreclosure and for other relief and requested a preliminary injunction, which was denied. The Renners appealed from such denial and obtained an injunction against foreclosure during its pendency.

Opinion.

Court of Appeal, Fourth Appellate District, Division Two, State of California

Nini Myrna Tan, et al., Plaintiffs and Appellants, v. California Federal Savings and Loan Association, et al., Defendants and Respondents. 4 Civil 23471, (Super.Ct.No. 290177).

APPEAL from an order of the Superior Court of Orange County. Edward J. Wallin, Judge. Reversed.

Fred Crane and Mark A. Hiller for Plaintiffs and Appellants.

William W. Berryhill and Cohen & Ziskin, Terry S. Kaplan and Peter D. Collisson for Defendants and Respondents.

This is an appeal following the trial court's sustention of a demurrer to plaintiffs' complaint for declaratory and injunctive relief to prevent foreclosure by trustee's sale of a deed of trust encumbering residential real property purchased by them. The dispositive issue is whether federal preemption precludes application to a federally chartered savings and loan association of the rule in *Wellenkamp v. Bank of America* (1978) 21 Cal.3d 943, that an institutional lender may not exercise a due-on-sale clause in a deed of trust encumbering residential real property unless the sale or transfer of the property has impaired or threatens to impair the security. The disposition of the appeal is governed by our opinion in the case of *Reginald D. de la Cuesta, et al. v. Fidelity Federal Savings & Loan Association, et al.*, 4 Civil 23253, certified for publication and filed contemporaneously with this opinion.

FACTS.

This action was commenced by plaintiffs Eugenie Gosling and Nini Myrna Tan seeking, primarily, declaratory and injunctive relief against the threatened foreclosure by trustee's sale of a deed of trust encumbering their residential real property following the purported exercise of a due-on-sale provision in the deed of trust by the defendant California Federal Savings and Loan Association (hereafter California Federal), the beneficiary named in the deed of trust.

California Federal demurred to the complaint on the ground that federal preemption precludes application of the *Wellenkamp* rule to a federally chartered savings and loan association. The trial court sustained the demurrer granting plaintiffs leave to amend. Having elected not to amend, plaintiffs appeal from the ensuing judgment dismissing the action.

California Federal is a private mutual savings and loan association chartered by the Federal Home Loan Bank Board pursuant to Section 5(a) of the Federal Home Owners' Loan Act of 1933 (12 U.S.C. § 1461 et seq.). On April 5, 1976, California Federal made a loan of $102,800 to Raymond G. and Juli A. Wilson secured by a deed of trust on their residential real property located at 4732 Pearce Street, Huntington Beach, in the State of California. The deed of trust contained a due-on-sale clause purportedly giving California Federal the right to declare the unpaid balance of the loan immediately due and payable in the event the property or any interest therein was sold or otherwise transferred or conveyed by the borrowers. It also contained, as paragraph numbered 15, the following provision: "15. LAW OF CALIFORNIA CONTROLLING. This Deed shall be construed according to the laws of the State of California."

On or about September 26, 1976, the Wilsons sold and conveyed the property to Richard L. and Doris I. Newman who took the property subject to the deed of trust. At the Newmans' request, California Federal agreed to accept their loan payments under a reservation of rights agreement. The Newmans then sold partial undivided interest to Paul L. Callihan. Together, the Newmans and Paul Callihan sold and conveyed the property to Philip V. and Marie Currie. The Curries then sold a partial undivided interest in the property to George Gosling. Except for the original transfer from the Wilsons to the Newmans, California Federal apparently had no knowledge of the intervening transfers. On April 17, 1977, the Curries and George Gosling sold and conveyed the property to plaintiffs.

On or about June 9, 1977, plaintiffs' attorney advised California Federal that the property had been sold and conveyed to plaintiffs and requested that California Federal execute a reservation of rights agreement. Having learned of the intervening transfers, California Federal refused to execute a new reservation of rights agreement with plaintiffs and stated that the original Newman reservation of rights agreement should be assigned to plaintiffs and executed by the intervening transferees. Plaintiffs refused to abide by that procedure.

California Federal then gave notice that it was exercising the due-on-sale clause in the deed of trust, and on April 18, 1978, caused to be recorded a notice of default and election to sell under the deed of trust. Whereupon, this action was instituted.

DISCUSSION AND DISPOSITION.

For the reasons stated and upon the authorities cited in our opinion filed contemporaneously herewith in *Reginald de la Cuesta, et al. v. Fidelity Federal Savings & Loan*

Association, 4 Civil 23253, we conclude that application of the state law as set forth in *Wellenkamp* is not precluded by federal preemption and that the *Wellenkamp* rule is applicable in this case.

Accordingly, the judgment is reversed for further proceedings consistent with this opinion and that in 4 Civil 23253.

KAUFMAN
Acting P.J.

We concur:

MC DANIEL, J.

Morris, J.

Modification of Opinion.

Court of Appeal, Fourth Appellate District, Division Two, State of California.

Nini Myrna Tan, et al., Plaintiffs and Appellants, v. California Federal Savings and Loan Association, et al., Defendants and Respondents. 4 Civil 23471. (Super.Ct.No. 290177).

Filed: July 5, 1981.

Appellants have filed a motion for modification and a request that we certify the opinion filed July 2, 1981 for publication.

We grant the motion to more accurately state facts not included in the opinion, but, having resolved all the "QUESTIONS PRESENTED" as set forth on page one of the Appellants' Opening Brief and being of the view that the opinion is of no precedential value over and above that in *de la Cuesta, et al. v. Fidelity Federal Savings & Loan Association, et al.*, 4 Civil 23253, the motion and request are denied in all other respects.

Accordingly, the opinion filed July 2, 1981, is hereby modified as follows:

1. On page 1, in the second and third lines of the first paragraph following the appearances after the words "complaint for declaratory" delete the words "and injunctive relief to prevent" and insert in lieu thereof the words "relief and damages with respect to defendants' threatened".

2. In line 5 of the same paragraph, delete the word "them" and insert in lieu thereof the word "plaintiffs".

3. On page 2 following the end of the first paragraph under the heading *"FACTS"* insert the following paragraph:

> "After obtaining a preliminary injunction, plaintiffs sold the property to persons not parties to this action. As a condition of reconveyance, California Federal

demanded and received, in addition to the unpaid balance of principal and interest, payment of a prepayment penalty of $3,688.80 and foreclosure costs in the amount of $1,512.98, to which plaintiffs objected. Plaintiffs filed an amended and supplemental complaint seeking damages for California Federal's alleged wrongful conduct in this regard."

On page 2 in the second paragraph under the heading "*FACTS*" immediately before the word "complaint" in line one insert the words "amended and supplemental."

Except as modified the opinion remains the same and the judgment is unaffected.

Except as granted hereinabove the motion and request are denied.

KAUFMAN
Acting P.J.

I concur:

MC DANIEL, J.

CLERK'S OFFICE, SUPREME COURT
4250 STATE BUILDING
SAN FRANCISCO, CALIFORNIA 94102

I have this day filed Order, August 26, 1981 HEARING DENIED.

In re: 4 CIV. No. 23471, TAN vs. CALIF. FED. S&L.

Respectfully,

Clerk

Opinion.

Court of Appeal, Fourth Appellate District, Division Two, State of California.

William Romagnoli, et al., Plaintiffs and Appellants, v. California Federal Savings and Loan Association, Defendant and Respondent. 4 Civil 23023. (Super.Ct.No. 322354).

Filed: July 2, 1981.

APPEAL from an order of the Superior Court of Orange County. Robert C. Todd, Judge. Reversed with directions.

Fred Crane for Plaintiffs and Appellants.

Lloyd F. Dunn, Robert John Jensen, Daniel S. McDonald, William W. Berryhill, William L. Callender, JeRome E. Tarver and Donald Perry Rhoads for Defendant and Respondent.

This is an appeal from an order denying plaintiffs a preliminary injunction to restrain foreclosure by trustee's sale of a deed of trust encumbering residential real property purchased by them. The dispositive issue is whether federal preemption precludes application to a federally chartered savings and loan association of the rule in *Wellenkamp v. Bank of America* (1978) 21 Cal.3d 943, that an institutional lender may not exercise a due-on-sale clause in a deed of trust encumbering residential real property unless the sale or transfer of the property has impaired or threatens to impair the security. The disposition of the appeal is governed by our opinion in the case of *Reginald D. de la Cuesta, et al. v. Fidelity Federal Savings & Loan Association, et al.*, 4 Civil 23253, certified for publication and filed contemporaneously with this opinion.

FACTS.

This action was commenced by plaintiffs William and Felice Romagnoli seeking, primarily, declaratory and injunctive relief against the threatened foreclosure by trustee's sale of a deed of trust encumbering their residential real property following the purported exercise of a due-on-sale provision in the deed of trust by the defendant California Federal Savings and Loan Association (hereafter California Federal), the beneficiary named in the deed of trust.

Plaintiffs sought a preliminary injunction to restrain the sale on the ground that exercise of the due-on-sale clause was precluded by *Wellenkamp*. California Federal opposed issuance of a preliminary injunction on the ground that federal preemption precludes application of the *Wellenkamp* rule to a federally chartered savings and loan association. The trial court denied the preliminary injunction and plaintiffs appeal.

California Federal is a private mutual savings and loan association chartered by the Federal Home Loan Bank Board pursuant to Section 5(a) of the Federal Home Owners' Loan Act of 1933 (12 U.S.C. § 1461 et seq.). On December 11, 1973, California Federal made a loan of $40,800 to Les H. and Carole M. Amoy secured by a deed of trust on their residential real property located at 23542 Via Calazdor, Mission Viejo, in the State of California. The deed of trust contained a due-on-sale clause purportedly giving California Federal the right to declare the unpaid balance of the loan immediately due and payable in the event the property or any interest therein was sold or otherwise transferred or conveyed by the borrowers. It also contained as paragraph numbered 15, the following provision: "15. LAW OF CALIFORNIA CONTROLLING. This Deed shall be construed according to the laws of the State of California."

On July 16, 1979, the Amoys sold and conveyed the property to plaintiffs.

Having learned of the July 16 transfer of the property, California Federal gave notice that it was exercising the due-on-sale clause in the deed of trust, and on September 12, 1979, caused to be recorded a notice of default and election to sell under the deed of trust. Whereupon this action was instituted.

DISCUSSION AND DISPOSITION.

For the reasons stated and upon the authorities cited in our opinion filed contemporaneously herewith in *Reginald de la Cuesta, et al. v. Fidelity Federal Savings & Loan Association*, 4 Civil 23253, we conclude that application of the state law as set forth in *Wellenkamp* is not precluded by federal preemption and that the *Wellenkamp* rule is applicable in this case.

While the issuance or denial of a preliminary injunction ordinarily is a matter addressed to the judicial discretion of the trial court (*Continental Baking Co. v. Katz* (1968) 68 Cal.2d 512, 528; *Gosney v. State of California* (1970) 10 Cal.App.3d 921, 924), here the denial was based entirely on the legal proposition that the *Wellenkamp* rule was inapplicable because of federal preemption. Inasmuch as we have concluded that the *Wellenkamp* rule is applicable, sound judicial discretion can only be exercised in one way, by issuing the preliminary injunction.

Accordingly, the order is reversed with directions to the trial court to issue the preliminary injunction.

KAUFMAN
Acting P.J.

We concur:

MC DANIEL, J.

MORRIS, J.

Opinion.

Court of Appeal, Fourth Appellate District, Division Two, State of California.

California Federal Savings and Loan Association, Plaintiff and Respondent, v. H. La Verne Smith, et al., Defendant.

Michael J. Dunn, et al., Cross-complainants and Appellants, v. California Federal Savings and Loan Association, Cross-Defendant and Respondent. 4 Civil 23201. (Super.Ct.No. 114562).

APPEAL from an order of the Superior Court of Riverside County. J. David Hennigan, Judge. Reversed with directions.

Lloyd F. Dunn, Robert John Jensen, Daniel S. McDonald, William W. Berryhill, William L. Callender, JeRome E. Tarver and Donald Perry Rhoads for Plaintiff, Cross-Defendant and Respondent.

Fred Crane for Cross-Complainants and Appellants.

This is an appeal from an order denying defendants and cross-complainants a preliminary injunction to restrain foreclosure by trustee's sale of a deed of trust encumbering residential real property purchased by them. The dispositive issue is whether federal preemption precludes application to a federally chartered savings and loan association of the rule in *Wellenkamp v. Bank of America* (1978) 21 Cal.3d 943, that an institutional lender may not exercise a due-on-sale clause in a deed of trust encumbering residential real property unless the sale or transfer of the property has impaired or threatens to impair the security. The disposition of the appeal is governed by our opinion in the case of *Reginald D. de la Cuesta, et al. v. Fidelity Federal Savings & Loan Association, et al.*, 4 Civil 23253, certified for publication and filed contemporaneously with this opinion.

FACTS.

This action was commenced by plaintiff California Federal Savings and Loan Association (hereafter California Federal) against the defendants Michael J. and Dianne R. Dunn and their predecessors in interest. California Federal, as the beneficiary named in a deed of trust encumbering residential real property, sought declaratory relief and judicial foreclosure following the exercise of a due-on-sale provision in the deed of trust. The Dunns filed a cross-complaint seeking, primarily, declaratory and injunctive relief against the threatened foreclosure by trustee's sale of the deed of trust encumbering their real property.

Defendants and cross-complainants then sought a preliminary injunction to restrain the sale on the ground that exercise of the due-on-sale clause was precluded by *Wellenkamp*. California Federal opposed issuance of a preliminary injunction on the ground that federal preemption precludes application of the *Wellenkamp* rule to a federally chartered savings and loan association. The trial court denied the preliminary injunction and the Dunns appeal.

California Federal is a private mutual savings and loan association chartered by the Federal Home Loan Bank Board pursuant to Section 5(a) of the Federal Home Owners' Loan Act of 1933 (12 U.S.C. § 1461 et seq.). On April 30, 1973, California Federal made a loan of $32,700 to H. La Verne and Alma P. Smith secured by a deed of trust on their residential real property located at 5748 Old Ranch Road, Riverside, in the State of California. The deed of trust contained a due-on-sale clause purportedly giving California Federal the right to declare the unpaid balance of the loan immediately due and payable in the event the property or any interest therein was sold or otherwise transferred or conveyed by the borrowers. It also contained as paragraph

numbered 15, the following provision: "15. LAW OF CALIFORNIA CONTROLLING. This Deed shall be construed according to the laws of the State of California."

On June 12, 1975, the Smiths sold and conveyed the property to plaintiffs.

Having learned of the June 12 transfer of the property, California Federal gave notice that it was exercising the due-on-sale clause in the deed of trust, and on December 19, 1975, caused to be recorded a notice of default and election to sell under the deed of trust. Whereupon this action was instituted.

DISCUSSION AND DISPOSITION.

For the reasons stated and upon the authorities cited in our opinion filed contemporaneously herewith in *Reginald de la Cuesta, et al. v. Fidelity Federal Savings & Loan Association,* 4 Civil 23253, we conclude that application of the state law as set forth in *Wellenkamp* is not precluded by federal preemption and that the *Wellenkamp* rule is applicable in this case.

While the issuance or denial of a preliminary injunction ordinarily is a matter addressed to the judicial discretion of the trial court (*Continental Baking Co. v. Katz* (1968) 68 Cal.2d 512, 528; *Gosney v. State of California* (1970) 10 Cal.App.3d 921, 924), here the denial was based entirely on the legal proposition that the *Wellenkamp* rule was inapplicable because of federal preemption. Inasmuch as we have concluded that the *Wellenkamp* rule is applicable, sound judicial discretion can only be exercised in one way, by issuing the preliminary injunction.

Accordingly, the order is reversed with directions to the trial court to issue the preliminary injunction.

KAUFMAN
Acting P.J.

We concur:

MC DANIEL, J.

MORRIS, J.

Opinion.

Court of Appeal, Fourth Appellate District, Division Two, State of California.

George A. Hanlon, et al., Plaintiffs and Appellants, v. California Federal Savings and Loan Association, Defendant and Respondent. 4 Civil 23103. (Super.Ct.No. 323256).

Filed: July 2, 1981.

APPEAL from an order of the Superior Court of Orange County. Robert C. Todd, Judge. Reversed with directions.

Fred Crane for Plaintiffs and Appellants.

Lloyd F. Dunn, Robert John Jensen, Daniel S. McDonald, William W. Berryhill, William L. Callender, JeRome E. Tarver and Donald Perry Rhoads for Defendant and Respondent.

This is an appeal from an order denying plaintiffs a preliminary injunction to restrain foreclosure by trustee's sale of a deed of trust encumbering residential real property purchased by them. The dispositive issue is whether federal preemption precludes application to a federally chartered savings and loan association of the rule in *Wellenkamp v. Bank of America* (1978) 21 Cal.3d 943, that an institutional lender may not exercise a due-on-sale clause in a deed of trust encumbering residential real property unless the sale or transfer of the property has impaired or threatens to impair the security. The disposition of the appeal is governed by our opinion in the case of *Reginald D. de la Cuesta, et al. v. Fidelity Federal Savings & Loan Association, et al.*, 4 Civil 23253, certified for publication and filed contemporaneously with this opinion.

FACTS.

This action was commenced by plaintiffs George A. and Janis E. Hanlon seeking, primarily, declaratory and injunctive relief against the threatened foreclosure by trustee's

sale of a deed of trust encumbering their residential real property following the purported exercise of a due-on-sale provision in the deed of trust by the defendant California Federal Savings and Loan Association (hereinafter California Federal), the beneficiary named in the deed of trust.

Plaintiffs sought a preliminary injunction to restrain the sale on the ground that exercise of the due-on-sale clause was precluded by *Wellenkamp*. California Federal opposed issuance of a preliminary injunction on the ground that federal preemption precludes application of the *Wellenkamp* rule to a federally chartered savings and loan association. The trial court denied the preliminary injunction and plaintiffs appeal.

California Federal is a private mutual savings and loan association chartered by the Federal Home Loan Bank Board pursuant to Section 5(a) of the Federal Home Owners' Loan Act of 1933 (12 U.S.C. § 1461 et seq.). On October 10, 1977, California Federal made a loan of $50,500 to Richard P. and Marilyn A. Stenzel secured by a deed trust on their residential real property located at 23431 Caminito Juanico, Laguna Hills, in the State of California. The deed of trust contained a due-on-sale clause purportedly giving Californa Federal the right to declare the unpaid balance of the loan immediately due and payable in the event the property or any interest therein was sold or otherwise transferred or conveyed by the borrowers. It also contained as paragraph numbered 15, the following provision:

"15. UNIFORM DEED OF TRUST: GOVERNING LAW: SEVERABILITY: This form deed of trust combines uniform covenants for national use and non-uniform covenants by jurisdiction to constitute a uniform security instrument covering real property. This Deed of Trust shall be governed by the law of the jurisdiction in which the Property is located."

On August 1, 1979, the Stenzels sold and conveyed the property to plaintiffs.

Having learned of the August 1 transfer of the property, California Federal gave notice that it was exercising the due-on-sale clause in the deed of trust, and on September 21, 1979, caused to be recorded a notice of default and election to sell under the deed of trust. Whereupon this action was instituted.

DISCUSSION AND DISPOSITION.

For the reasons stated and upon the authorities cited in our opinion filed contemporaneously herewith in *Reginald de la Cuesta, et al. v. Fidelity Federal Savings & Loan Association*, 4 Civil 23253, we conclude that application of the state law as set forth in *Wellenkamp* is not precluded by federal preemption and that the *Wellenkamp* rule is applicable in this case.

While the issuance or denial of a preliminary injunction ordinarily is a matter addressed to the judicial discretion of the trial court (*Continental Banking Co. v. Katz* (1968) 68 Cal.2d 512, 528; *Gosney v. State of California* (1970) 10 Cal.App.3d 921, 924), here the denial was based entirely on the legal proposition that the *Wellenkamp* rule was inapplicable because of federal preemption. Inasmuch as we have concluded that the *Wellenkamp* rule is applicable, sound judicial discretion can only be exercised in one way, by issuing the preliminary injunction.

Accordingly, the order is reversed with directions to the trial court to issue the preliminary injunction.

KAUFMAN
Acting P.J.

We concur:

MC DANIEL, J.
MORRIS, J.

Opinion.

Court of Appeal, Fourth Appellate District, Division Two, State of California.

William A. Renner, et al., Plaintiffs and Appellants, v. California Federal Savings and Loan Association, Defendant and Respondent. 4 Civil 23341. (Super.Ct.No. 133825).

Filed: July 2, 1981.

APPEAL from an order of the Superior Court of Riverside County. George C. Grover, Judge. Reversed with directions.

Fred Crane for Plaintiffs and Appellants.

Lloyd F. Dunn, Robert John Jensen, Daniel S. McDonald, William W. Berryhill, William L. Callender, JeRome E. Tarver and Donald Perry Rhoads for Defendant and Respondent.

This is an appeal from an order denying plaintiffs a preliminary injunction to restrain foreclosure by trustee's sale of a deed of trust encumbering residential real property purchased by them. The dispositive issue is whether federal preemption precludes application to a federally chartered savings and loan association of the rule in *Wellenkamp v. Bank of America* (1978) 21 Cal.3d 943, that an institutional lender may not exercise a due-on-sale clause in a deed of trust encumbering residential real property unless the sale or transfer of the property has impaired or threatens to impair the security. The disposition of the appeal is governed by our opinion in the case of *Reginald D. de la Cuesta, et al. v. Fidelity Federal Savings & Loan Association, et al.*, 4 Civil 23253, certified for publication and filed contemporaneously with this opinion.

FACTS.

This action was commenced by plaintiffs William A. and Beverly E. Renner seeking, primarily, declaratory and injunctive relief against the threatened foreclosure by trustee's sale of a deed of trust encumbering their residential real property following the purported exercise of a due-on-sale provision in the deed of trust by the defendant California Federal Savings and Loan Association (hereafter California Federal), the beneficiary named in the deed of trust.

Plaintiffs sought a preliminary injunction to restrain the sale on the ground that exercise of the due-on-sale clause was precluded by *Wellenkamp*. California Federal opposed issuance of a preliminary injunction on the ground that fed-

eral preemption precludes application of the *Wellenkamp* rule to a federally chartered savings and loan association. The trial court denied the preliminary injunction and plaintiffs appeal.

California Federal is a private mutual savings and loan association chartered by the Federal Home Loan Bank Board pursuant to Section 5(a) of the Federal Home Owners' Loan Act of 1933 (12 U.S.C. § 1461 et seq.). On June 16, 1977, California Federal made a loan of $54,400 to Gary M. and Catherine T. Funk secured by a deed of trust on their residential real property located at 6765 Sunset Circle, Riverside, in the State of California. The deed of trust contained a due-on-sale clause purportedly giving California Federal the right to declare the unpaid balance of the loan immediately due and payable in the event the property or any interest therein was sold or otherwise transferred or conveyed by the borrowers. It also contained as paragraph numbered 15, the following provision: "15. LAW OF CALIFORNIA CONTROLLING. This Deed shall be construed according to the laws of the State of California."

On April 30, 1979, the Funks sold and conveyed the property to plaintiffs.

Having learned of the April 30 transfer of the property, California Federal gave notice that it was exercising the due-on-sale clause in the deed of trust, and on September 21, 1979, caused to be recorded a notice of default and election to sell under the deed of trust. Whereupon this action was instituted.

DISCUSSION AND DISPOSITION.

For the reasons stated and upon the authorities cited in our opinion filed contemporaneously herewith in *Reginald de la Cuesta, et al. v. Fidelity Federal Savings & Loan Association*, 4 Civil 23253, we conclude that application

of the state law as set forth in *Wellenkamp* is not precluded by federal preemption and that the *Wellenkamp* rule is applicable in this case.

While the issuance or denial of a preliminary injunction ordinarily is a matter addressed to the judicial discretion of the trial court (*Continental Baking Co. v. Katz* (1968) 68 Cal.2d 512, 528; *Gosney v. State of California* (1970) 10 Cal.App.3d 921, 924), here the denial was based entirely on the legal proposition that the *Wellenkamp* rule was inapplicable because of federal preemption. Inasmuch as we have concluded that the *Wellenkamp* rule is applicable, sound judicial discretion can only be exercised in one way, by issuing the preliminary injunction.

Accordingly, the order is reversed with directions to the trial court to issue the preliminary injunction.

KAUFMAN
Acting P.J.

We concur:

MC DANIEL, J.

MORRIS, J.

Opinion.

Court of Appeal, Fourth Appellate District, Division Two, State of California.

John William Ben, et al., Plaintiffs and Appellants, v. California Federal Savings and Loan Association, Defendant and Respondent. 4 Civil 23102. (Super.Ct.No. 323255).

Filed: July 2, 1981.

APPEAL from an order of the Superior Court of Orange County. Robert C. Todd, Judge. Reversed with directions.

Fred Crane for Plaintiffs and Appellants.

Lloyd F. Dunn, Robert John Jensen, Daniel S. McDonald, William W. Berryhill, William L. Callender, JeRome E. Tarver and Donald Perry Rhoads for Defendant and Respondent.

This is an appeal from an order denying plaintiffs a preliminary injunction to restrain foreclosure by trustee's sale of a deed of trust encumbering residential real property purchased by them. The dispositive issue is whether federal preemption precludes application to a federally chartered savings and loan association of the rule in *Wellenkamp v. Bank of America* (1978) 21 Cal.3d 943, that an institutional lender may not exercise a due-on-sale clause in a deed of trust encumbering residential real property unless the sale or transfer of the property has impaired or threatens to impair the security. The disposition of the appeal is governed by our opinion in the case of *Reginald D. de la Cuesta, et al. v. Fidelity Federal Savings & Loan Association, et al.*, 4 Civil 23253, certified for publication and filed contemporaneously with this opinion.

FACTS.

This action was commenced by plaintiffs John William and Sarah L. Ben seeking, primarily, declaratory and injunctive relief against the threate ıed foreclosure by trustee's

sale of a deed of trust encumbering their residential real property following the purported exercise of a due-on-sale provision in the deed of trust by the defendant California Federal Savings and Loan Association (hereafter California Federal), the beneficiary named in the deed of trust.

Plaintiffs sought a preliminary injunction to restrain the sale on the ground that exercise of the due-on-sale clause was precluded by *Wellenkamp*. California Federal opposed issuance of a preliminary injunction on the ground that federal preemption precludes application of the *Wellenkamp* rule to a federally chartered savings and loan association. The trial court denied the preliminary injunction and plaintiffs appeal.

California Federal is a private mutual savings and loan association chartered by the Federal Home Loan Bank Board pursuant to Section 5(a) of the Federal Home Owners' Loan Act of 1933 (12 U.S.C. § 1461 et seq.). On May 5, 1977, California Federal made a loan of $52,000 to James M. and Jeanne A. McCrary and Sesil O. and Sharon R. Adams secured by a deed of trust on their residential real property located at 26131 Camino Adelanto, Mission Viejo, in the State of California. The deed of trust contained a due-on-sale clause purportedly giving California Federal the right to declare the unpaid balance of the loan immediately due and payable in the event the property or any interest therein was sold or otherwise transferred or conveyed by the borrowers. It also contained as paragraph numbered 15, the following provision:

"15. LAW OF CALIFORNIA CONTROLLING: This Deed shall be construed according to the laws of the State of California."

On November 20, 1978, the McCrarys and Adams sold and conveyed the property to plaintiffs.

Having learned of the November 20 transfer of the property, California Federal instituted an action in federal district court against the McCrarys and the Adams for declaratory relief and for judicial foreclosure under the deed of trust. The district court dismissed the action for lack of subject matter jurisdiction. California Federal then gave notice that it was exercising the due-on-sale clause in the deed of trust, and on September 21, 1979, caused to be recorded a notice of default and election to sell under the deed of trust. Whereupon this action was instituted.

DISCUSSION AND DISPOSITION.

For the reasons stated and upon the authorities cited in our opinion filed contemporaneously herewith in *Reginald de la Cuesta, et al. v. Fidelity Federal Savings & Loan Association*, 4 Civil 23253, we conclude that application of the state law as set forth in *Wellenkamp* is not precluded by federal preemption and that the *Wellenkamp* rule is applicable in this case.

While the issuance or denial of a preliminary injunction ordinarily is a matter addressed to the judicial discretion of the trial court (*Continental Baking Co. v. Katz* (1968) 68 Cal.2d 512, 528; *Gosney v. State of California* (1970) 10 Cal.App.3d 921, 924), here the denial was based entirely on the legal proposition that the *Wellenkamp* rule was inapplicable because of federal preemption. Inasmuch as we have concluded that the *Wellenkamp* rule is applicable, sound judicial discretion can only be exercised in one way, by issuing the preliminary injunction.

Accordingly, the order is reversed with directions to the trial court to issue the preliminary injunction.

KAUFMAN
Acting P.J.

We concur:
MC DANIEL, J.
Morris, J.

CLERK'S OFFICE, SUPREME COURT
4250 STATE BUILDING
SAN FRANCISCO, CALIFORNIA 94102

I have this day filed Order, August 26, 1981, HEARING DENIED

In re: 4 cv. No. 23023, ROMAGNOLI vs. CALIFORNIA FEDERAL.

Respectfully,

Clerk

U.S. Constitution Article I, §10

No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.

U.S. Constitution Article VI, Clause 2

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Cal. Constitution Article 1, §9

No bill of attainder, ex post facto law, or law impairing the obligation of contracts shall ever be passed.

Home Owners' Loan Act of 1933, 12 U.S.C. §1464(a)

(a)(1) In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as "Federal Savings and Loan Associations", or "Federal mutual savings banks" (but only in the case of institutions which, prior to conversion, were State mutual savings banks located in States which authorize the chartering of State mutual savings banks, provided such conversion is not in contravention of State law), and to issue charters therefor, giving primary consideration o the best practices of local

mutual thrift and home-financing institutions in the United States. An association which was formerly organized as a savings bank under State law may not convert from the mutual to the stock form of ownership. An association which was formerly organized as a savings bank under State law may not convert from the mutual to the stock form of ownership. An association which was formally organized as a savings bank under State law may, to the extent authorized by the Board, continue to carry on any activities it was engaged in on December 31, 1977, and to retain or make any investments of a type it held on that date, except that its equity, corporate bond, and consumer loan investments may not exceed the average ratio of such investments to total assets for the five-year period immediately preceding the filing of an application for conversion and such an association which was formerly organized as a savings bank under State law shall only be permitted to establish branch offices and other facilities in accordance with the limitations imposed by State law controlling applications of a savings bank organized under such State law, provided that such an association: (A) shall be exempt from any numerical limitations of State law on the establishment of branch offices and other facilities, and (B) may, in any case, subject to the approval of the Board, establish branch offices and other facilities in its own Standard Metropolitan Statistical Area, its own county or within thirty-five miles of its home office, but only in its State of domicile. An association which was formerly organized as a savings bank under State law shall be subject to the requirements of State law (including any regulations promulgated thereunder and any sanction for the violation of any such law or regulation) in effect at the time of conversion, in the State of its original charter —

(A) pertaining to discrimination in the extension of home mortgage loans or adjustment in the terms of mortgage instruments based on neighborhood or geographical area,

(B) pertaining to requirements imposed under the Consumer Credit Protection Act,

if the Board determines that State law and regulations impose more stringent requirements than Federal law and regulations.

(2) A Federal mutual savings bank may make commercial, corporate, and business loans except that —

(A) not more than 5 per centum of the assets of such a bank may be so loaned; and

(B) such loans may only be made within the State where the bank is located or within 75 miles of the bank's home office.

(3) In addition to the authority conferred by paragraph (1), Federal mutual savings bank may accept demand deposits in connection with a commercial, corporate, or business loan relationship.

28 U.S.C. §1257 State Courts; appeal; certiorari

Final judgments or decrees rendered by the highest court of a State in which a decision could be had, may be reviewed by the Supreme Court as follows:

(1) By appeal, where is drawn in question the validity of a treaty or statute of the United States and the decision is against its validity.

(2) By appeal, where in drawn in question the validity of a statute of any state on the ground of its being repugnant to the Constitution, treaties or laws of the United States, and the decision is in favor of its validity.

(3) By writ of certiorari, where the validity of a treaty or statute of the United States is drawn in question or where

the validity of a State statute is drawn in question on the ground of its being repugnant to the Constitution, treaties or laws of the United States, or where any title, right, privilege or immunity is specially set up or claimed under the Constitution, treaties or statutes of, or commission held or authority exercised under, the United States.

California Civil Code §711.

Conditions restraining alienation, when repugnant to the interest created, are void.

12 C.F.R. §545.8-3(f) & (g)

(f) Due-on-sale clauses. An association continues to have the power to include, as a matter of contract between it and the borrower, a provision in its loan instrument whereby the association may, at its option, declare immediately due and payable sums secured by the association's security instrument if all or any part of the real property securing the loan is sold or transferred by the borrower without the association's prior written consent. Except as provided in paragraph (g) of this section with respect to loans made after July 31, 1976, on the security of a home occupied or to be occupied by the borrower, exercise by the association of such option (hereafter called a due-on-sale clause) shall be exclusively governed by the terms of the loan contract, and all rights and remedies of the association and borrower shall be fixed and governed by that contract.

(g) Limitations on the exercise of due-on-sale clauses. With respect to any loan made after July 31, 1976, on the security of a home occupied or to be occupied by the borrower, a Federal association: (1) Shall not exercise a due-on-sale clause because of (i) creation of a lien or other encumbrance subordinate to the association's security instrument, (ii) creation of a purchase money security interest

for household appliances; (iii) transfer by devise, descent, or operation of law on the death of a joint tenant; or (iv) granting of a leasehold interest of three years or less not containing an option to purchase; (2) shall not impose a prepayment charge or equivalent fee for acceleration of the loan by exercise of a due-on-sale clause; and (3) waives its option to exercise a due-on-sale clause as to a specific transfer if, before the transfer, the association and the person to whom the property is to be sold or transferred (the existing borrower's successor in interest) agree in writing that the person's credit is satisfactory to the association and that interest on sums secured by the association's security interest will be payable at a rate the association shall request. Upon such agreement and resultant waiver the association shall release the existing borrower from all obligations under the loan instruments, and the association is deemed to have made a new loan to the existing borrower's successor in interest.

12 C.F.R. §556.9(f)

Imposition of late charges and due-on-sale clauses.

(f) Due-on-sale policy and Federal preemption. (1) Federal associations are obliged to take reasonable precautions to protect themselves against the economic risks associated with mortgage lending, including the risk that the cost of lendable funds will exceed the yield from existing mortgage loans, and that sharply rising interest rates will reduce substantially the value of existing mortgage assets. In this connection, the Board has determined that the due-on-sale clause normally is a valuable and often an indispensable source of protection for the financial soundness of Federal associations and for their continued ability to fund new home loan commitments. Consequently, the Board for many years has authorized due-on-sale clauses for use by Federal as-

sociations. However, because the Board desires to afford associations the flexibility to accommodate special situations and circumstances, §545.8-3(f) of this Subchapter by its terms merely authorizes rather than compels the inclusion and exercise of due-on-sale clauses in mortgage loans.

(2) Paragraph (f) of §545.8-3 confirms the continuing authority of Federal associations to include due-on-sale clauses in their mortgage loan contracts and to exercise such clauses, subject only to the express limitations contained in §545.8-3(g). Due-on-sale practices of Federal associations shall be governed exclusively by the Board's regulations, in preemption of and without regard to any limitations imposed by state law on either their inclusion or exercise (including, but not confined to, state law prohibitions against restraints on alienation, prohibitions against penalties and forfeitures, equitable restrictions and state law dealing with equitable transfers).

Advisory Opinion of the Federal Home Loan Bank Board.

United States of America. Before the Federal Home Loan Bank Board, July 30, 1975.

In the Matter of Eric R. Schott, *et al.*, Plaintiffs, v. Mission Federal Savings and Loan Association, *et al.*, Defendants. Case No. CIV-75-366 WMB, U.S.D.C. C.D. Cal. (Resolution No. 75-647).

INTRODUCTION.

This matter has been submitted to the Federal Home Loan Bank Board ("Board"), by Order of the Court in the captioned case, dated May 30, 1975, to obtain the Board's views and position with respect to certain issues in the subject case.

Pursuant to the Order of the Court referred to above, and the letter of the Board's General Counsel, dated April 28, 1975, the parties to the subject lawsuit have made written submissions to the Board addressed to the legal authorities and economic considerations involved in the utilization of "due on sale" clauses[1] in the loan instruments of the defendant Mission Federal Savings and Loan Association ("Mission Federal"), and other Federal savings and loan associations in California. The plaintiff's submissions consist of: affidavits of the plaintiff, Eric R. Schott, and his father, David Schott, describing the transactions between them and Mission Federal; copies of the loan documents and correspondence respecting the proposed loan at issue in this case; and Affidavit and Opening Argument of Jerome

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[1]While there are many variants of the "due on sale" clause in common use in security transactions in real property, they typically provide for the acceleration of the maturity of the loan — at the option of the lender — upon the sale or alienation by the borrower of the real property securing the loan.

Zamos, plaintiff's attorney (hereinafter "Opening Zamos Affidavit"); a Legal Memorandum on Submission to the Federal Home Loan Bank Board (hereinafter "Plaintiff's Memorandum"); a Reply Affidavit and Closing Argument of Jerome Zamos (hereinafter "Zamos Reply Affidavit"); and a Statement from the California Association of Realtors (hereinafter "California Realtors Statement").

Mission Federal's submissions consist of: a legal memorandum entitled "Presentation to the Federal Home Loan Bank Board" (hereinafter "Defendant's Presentation"); an affidavit of William L. Coulson, Jr., the President of Mission Federal (hereinafter "Coulson Affidavit"); a report prepared by Richard T. Pratt (a Professor of Finance at the University of Utah) entitled "The Due on Sale Clause in California and Federally Chartered Savings and Loan Associations" (hereinafter "Pratt Report"); and a "Response to Plaintiff's Affidavit and Opening Argument" (hereinafter "Defendant's Response").

The Board has based its Advisory Opinion upon the above submissions of the parties, and its own expertise and that of its staff. In addition, the Board also has considered a report, prepared by the economists on the Board's staff entitled "Opinion of the Office of Economic Research on the Revocation of the 'Due on Sale Clause' in California" (hereinafter "OER Opinion"), a copy of which is appended hereto as Exhibit No. 1. The Board's economists concluded as follows:

> "The Office of Economic Research [of the Board] views the revocation of the 'due on sale clause' as a factor that will lead to higher mortgage interest rates and will reduce the marketability of such mortgages in the secondary market. These two major points are made below, along with a number of minor points. This opinion was formed after reading the report by

Richard T. Pratt Associates and the plaintiff's reply thereto. Our conclusion is that the due on sale clause is an important part of the mortgage contract throughout the country, and its revocation sets a dangerous precedent in terms of the consequences in the mortgage market."

THE FACTS AS TO THE PARTICULAR CONTROVERSY BETWEEN PLAINTIFF AND MISSION FEDERAL

The material facts respecting the controversy between the plaintiff and Mission Federal do not appear to be in serious dispute.

On February 27, 1973, Mission Federal loaned the sum of $13,400 to Mr. and Mrs. Karl J. Eimer, to enable them to acquire — for their personal occupancy — a single family residence located at 616 Mulberry Avenue, Santa Barbara, California.[2] Mission Federal's loan to the Eimers had a term of 25 years, an interest rate of 7.5% per annum, and provided for amortization by payments of $100 per month. Mission Federal did not require that an impound (or escrow) account be established at the association by the Eimers for tax and insurance purposes.

Both the promissory note and deed or trust respecting the Eimer loan contained language — which was in italicized print — reading as follows:

> "Should the Trustor sell, convey, or alienate by Deed, contract or other means the herein described property or any part thereof or any interest therein, all obligations secured hereby irrespective of maturity dates, shall, at the option of the Beneficiary and without demand or notice, become immediately due and payable."

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[2]The Eimers paid $18,500 for this property.

Apparently, this was the standard language contained in all of Mission Federal's promissory notes and deeds of trust.

On about March 11, 1974, Mission Federal was notified that the Estado Home Loan Company had arranged for a second trust deed on the Eimer property, in the amount of $3,500, payable to Mr. and Mrs. Manuel S. Macias.

On November 14, 1974, Mission Federal received a notice from a local title insurance company, that an escrow had been opened for the sale of the Eimer residence. The escrow officer requested a statement from Mission Federal showing the present status of the loan, and Mission Federal, in turn, requested copies of the escrow instructions, execution by the buyers of a loan application with Mission Federal, and complete information as to any new secondary financing. Thereafter, Mission Federal received a copy of escrow instructions reflecting the proposed sale of the Eimer residence to Eric R. Schott, described as an "unmarried man", for a price of $23,000, $6,500 of which was to be paid in cash. According to Mission Federal, the escrow instructions also provided that "Seller to be guaranteed no liability after the close of escrow," and that Eric Schott was to "take over" the existing balance of the Mission Federal loan.

Eric Schott sent Mission Federal an application, dated November 18, 1974, for permission to assume the subject loan. This application reflected that Eric Schott was 19 years old, that he was employed as a ranch hand at a salary of $515 per month, and that he was purchasing the house at 616 Mulberry Avenue as an investment property. Mission Federal was concerned with the financial ability of Eric Schott to keep up the monthly payments on the loan, and it requested — and received — an additional guarantee from David Schott, Eric's father. Thereafter, Mission Federal

delivered a letter to Eric Schott, dated November 26, 1974 (which was addressed to both Eric and David Schott), advising them that their "application to assume our existing loan has been approved", and that their "interest rate will be 10¼% with monthly payments of $139.00 ($122.00 for principal and interest plus $17.00 for estimated tax and insurance impounds)."

Mission Federal states that the 10¼% interest rate offered to the Schotts was approximately ¼ of 1% under the then existing market rate for the particular type of loan at issue, and that the association follows the practice of allowing its existing loans to be assumed by credit-worthy borrowers at an interest rate of ¼ of 1% below the market at the time of the assumption.

On November 27, 1974, Mission Federal was advised that the escrow had closed without assumption of the association's loan, and that the Eimers had conveyed their total interest in the property to Eric Schott, individually, without securing the consent of Mission Federal to the conveyance.

After several discussions with Eric Schott's attorney, Jerome Zamos, involving, in major part, Mr. Zamos' contention that Mission Federal must consent to the assumption of the Eimer loan by Eric Schott *without any change in interest rate* or any of the other terms of the loan except for an impound requirement (provided David Schott acted as guarantor), Mission Federal declined to permit such assumption. When Mission Federal refused to accept Eric Schott's monthly installment payment on the Eimer loan, he made such payments (at the 7½% interest rate of the original Eimer loan) into an account which he opened in the name of Mission Federal at Crocker National Bank. Thereafter, pursuant to stipulation between counsel for the parties, the funds held in the Crocker National Bank account were

transferred into an interest-bearing savings account at Santa Barbara Savings and Loan Association, and Eric Schott has continued to deposit his monthly installment payments on the Eimer loan into the latter account.

On January 7, 1975, Mr. Zamos, on behalf of Eric Schott and others allegedly similarly situated, instituted a purported class action against Mission Federal, and other undesignated financial institutions, in the Superior Court of the State of California for the County of Santa Barbara. The Complaint (p. 7) alleged that Mission Federal, and other lending institutions, during the four-year period preceding the filing of the Complaint, collected in excess of $5 million of illegal interest charges (through the possible exercise of "due on sale clauses" in their loan instruments) forcing —

> ". . . members of the class . . . to execute written modification agreements increasing interest rates on existing loans from Defendants under the treat of interfering and preventing the close of escrows in which members of the class herein designated were attempting to acquire title to valuable real property or commencing foreclosure proceedings to take title to various properties away from members of the class herein designated."

Among other relief, the Complaint (p. 12) seeks that:

> "Defendants be required to account to Plaintiffs for all excess interest and installment payments made during the four year period prior to the filing of this action and pay to the members of the class herein designated the amount of such excess payments with interest at the rate of 7% per annum from the date such payments were made."

Following the institution of the class action referred to above, Mission Federal, by letter dated January 20, 1975 (copies of which were sent to Eric Schott and Mr. Zamos),

formally notified the Eimers that it had elected to exercise its option to declare all obligations immediately due under the promissory note and deed of trust because of the conveyance of their entire interest in the property at 616 Mulberry Avenue to Eric Schott. However, Mission Federal has agreed not to proceed to foreclosure pending determination of the legal position of the parties concerned.

Mission Federal removed the subject lawsuit from the State court referred to above to the United States District Court for the Central District of California. The plaintiff moved to remand the case to the State Court, and the Federal court has denied such motion.

ADVISORY OPINION OF THE FEDERAL HOME LOAN BANK BOARD

I

FEDERAL LAW EXCLUSIVELY GOVERNS THE VALIDITY OF "DUE ON SALE" CLAUSES IN THE LOAN INSTRUMENTS OF FEDERAL SAVINGS AND LOAN ASSOCIATIONS

The Board understands that in denying plaintiff's motion to remand, the Court already has decided that this case is to be governed by Federal law. The Board, nonetheless, believes that it would be appropriate and useful to the Court to express its views and position on the Federal preemption issues underlying this lawsuit.

The Board is an independent agency of the United States (12 U.S.C. 1437(b)), which is responsible, among other things, under the statutory power conferred upon it by section 5(a) of the Home Owners' Loan Act of 1933, as amended (hereafter "HOLA") (12 U.S.C. 1464(a)), for the chartering, supervision and regulation of Federal savings and loan associations.

Section 5(a) of the HOLA provides:

> "In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as 'Federal Savings and Loan Associations', and to issue charters therefor, giving primary consideration to the best practices of local mutual thrift and home-financing institutions in the United States."

Pursuant . . . this Congressionally delegated authority to "make policy", the Board has promulgated "comprehensive" regulations which govern "the powers and operations of every Federal savings and loan association from its cradle to its corporate grave." *California v. Coast Federal Savings & Loan Association*, 98 F. Supp. 311, 316 (S.D. Cal., 1951); *Meyers v. Beverly Hills Federal Savings & Loan Ass'n*, 499 F.2d 1145, 1147 (C.A. 9, 1974); *Kupiec v. Republic Federal Savings & Loan Ass'n*, 512 F.2d 147, 150 (C.A. 7, 1975). The courts uniformly have held that the HOLA has conferred unusually broad powers and discretion upon the Board to control and regulate the entire area of operations of Federal savings and loan associations. See, *e.g., North Arlington National Bank v. Kearny Federal Savings & Loan Ass'n.*, 187 F.2d 564, 565 (C.A. 3, 1951), *cert. denied*, 342 U.S. 816; *Bridgeport Federal Savings & Loan Ass'n. v. Federal Home Loan Bank Board*, 307 F.2d 580, 584 (C.A. 3, 1962), *cert. denied*, 371 U.S. 950 (1963); *Central Savings & Loan Ass'n of Chariton, Iowa v. Federal Home Loan Bank Board*, 293 F. Supp. 617, 621-622 (S.D. Iowa, 1968), *aff'd*, 422 F.2d 504 (C.A. 8, 1970); *Federal Home Loan Bank Board v. Rowe*, 284 F.2d 274,

277-278 (C.A.D.C., 1960); *Lyons Savings & Loan Ass'n v. Federal Home Loan Bank Board*, 377 F. Supp. 11 (N.D. Ill., 1974).

Federal savings and loan associations are agencies and instrumentalities of the United States. See, *e.g.*, *United States v. Harper*, 241 F.2d 103, 105 (C.A. 7, 1957); *First Federal Savings and Loan Ass'n v. Loomis*, 97 F.2d 831, 837 (C.A. 7, 1938); *Federal Savings and Loan Insurance Corp. v. Kearney Trust Co.*, 151 F.2d 720, 725 (C.A. 8, 1945); *Durnin v. Allentown Federal Sav. and Loan Assn.*, 218 F. Supp. 716, 718 (E.D. Pa., 1963). The case law makes it very clear that Federal law has preempted the operations of Federal savings and loan associations. For example, the Supreme Court of Florida held that:

> "By virtue of Title 12 U.S. Code, Section 1464 et seq., the Federal Government has preempted the regulation and supervision of federal savings and loan associations and the organization, incorporation, examination and operation of the same. . . ." *Washington Federal Savings and Loan Association v. Balaban*, 281 So.2d 15, 17 (1973).

This Court has reached the same conclusion. In the *Coast Federal* case, *supra*, which originated in a California State court and was removed to this Court, the California Attorney General sought an injunction and the recovery of statutory penalties against a Federal savings and loan association on the ground that it had transacted business in the manner of a bank and had held itself out as a bank or savings bank, leading the public to believe that it was a bank, in violation of State statutes. This Court dismissed the action, holding as follows:

> "Not only does the Act of Congress [HOLA], which authorized the creation, operation and supervision of federal savings and loan associations by the Home Loan

> Bank Board, embrace the entire field, but the comprehensive rules and regulations adopted by the Board clearly meet the test of covering the subject matter of the [State] statute. . . . It seems clear that Congress has preempted the field, making invalid the state statutes plaintiffs rely upon . . . when attempted to be invoked against a Federal savings and loan association.
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> . . .
>
> ". . . [A]s to federal savings and loan associations, Congress made plenary, preemptive delegation to the Board to organize, incorporate, supervise and regulate, *leaving no field for state supervision*" (98 F. Supp. at 318-319; emphasis added).

The rationale of the *Coast Federal* case recently was adopted by the Ninth Circuit in *Meyers v. Beverly Hills Federal Savings and Loan Ass'n*, 499 F.2d 1145 (1974). At issue in *Meyers* was whether a Board regulation respecting prepayment on the terms of mortgage loans made by Federal associations preempted the field so as to exempt Federal associations in California from State law dealing with the subject. The Ninth Circuit held that where the Board regulates an area "federal law preempts the field" so that "any California law in the area is inapplicable to federal savings and loan associations operating in California" (499 F.2d at 1147).

By the same token, it is equally clear that Federal savings and loan associations are not subject to State control. In this regard, one court has held that:

> ". . . [Pacific First Federal Savings and Loan Association], like all federal savings and loan associations, [is] completely federal in nature . . .
>
> * * *
>
> ". . . [I]t must be borne in mind that by reason of the complete federalization of [Pacific First Federal Savings and] Loan Association it is immune from any

type of control or regulation by state authority. . . ." *Elwert v. Pacific First Federal Savings & Loan Ass'n*, 138 F. Supp. 395, 399-400 (D. Ore., 1956).

Moreover, it recently has been held that —

". . . [T]he plenary powers given to the Board in the HOLA clearly evidence a Congressional intention to preempt the field, thus precluding any regulation of federal associations by state law. . . ." *Lyons Savings & Loan Ass'n v. Federal Home Loan Bank Board, supra*, 377 F. Supp. at 17.

The law as to Federal preemption over the operations of Federal savings and loan associations recently has been summed up by the U.S. District Court for the Eastern District of Wisconsin as follows:

"City, like other federal savings and loan associations organized under the Act [HOLA], operates under the FHLBB's * * * comprehensive regulations covering all aspects of every federal savings and loan association "from its cradle to its corporate grave." *People of State of California v. Coast Federal Savings & Loan Ass'n*. S.D. Cal., 1951, 98 F. Supp. 311, 316. * * *' *Meyers v. Beverly Hills Federal Savings & Loan Assn.*, 499 F.2d 1145, 1147 (9th Cir. 1974). The Act and the regulations promulgated by the FHLBB have been held to establish federal pre-emption over the regulation of federal savings and loan associations and thereby preclude any state legislation from applying. *Meyers v. Beverly Hills Federal Savings & Loan Assn., supra; Murphy v. Colonial Federal Savings and Loan Assn.*, 388 F.2d 609 (2d Cir. 1967); *Federal Savings & Loan Ins. Corp. v. Third National Bank in Nashville*, 153 F.2d 678 (6th Cir., *cert. denied*, 329 U.S. 718 (1946); *Federal Savings and Loan Ins. Corp. v. Kearney Trust Co.*, 151 F.2d 720 (8th Cir. 1945); *Durnin v. Allentown Federal Savings and Loan Assn.*, 218 F.

Supp. 716 (E.D. Pa. 1963); *Elwert v. Pacific First Federal Savings and Loan Assn. of Tacoma, Washington*, 138 F. Supp. 395 (D. Ore. 1956); *People of State of California v. Coast Federal Savings & Loan Assn.*, 98 F. Supp. 311 (S.D. Cal. 1951); *First Federal Savings & Loan Assn. of Wisconsin v. Finnegan*, 19 F. Supp. 678 (W.D. Wis. 1937), affirmed sub nom. *First Federal Savings & Loan Assn. of Wisconsin v. Loomis*, 97 F.2d 831 (7th Cir. 1938), cert. granted 305 U.S. 564 (1938), cert. dismissed *sub nom. Martin v. First Federal Savings and Loan Assn.*, 305 U.S. 666 (1939); *People v. Metrim Corp.*, 187 Cal. App.2d 289, 9 Cal. Rptr. 584 (1960); *Larwood Co. v. San Diego Federal Savings and Loan Assn.*, 185 Cal. App.2d 450, 8 Cal. Rptr. 362 (1960); *Pearson v. First Federal Savings and Loan Assn. of Tarpon Springs*, 149 So.2d 891 (Fla. App. 1963); *Ochs v. Washington Heights Federal Savings and Loan Assn.*, 17 N.Y.2d 82, 268 N.Y.S.2d 294, 215 N.E.2d 485 (1966). But see, *First Federal Savings and Loan Assn. of Atlanta v. Norwood Realty Co.*, 212 Ga. 524, 93 S.E.2d 763 (1956).

"The exclusivity of federal law means that when state courts 'deal with the internal affairs of federal savings and loan associations, * * * they are nonetheless applying federal law.' *Murphy v. Colonial Federal Savings and Loan Assn.*, 388 F.2d 609, 612 (1967). See, *Local 174 v. Lucas Flour Co.*, 369 U.S. 95 (1962).

"The fiduciary duties of officers and directors to a federal savings and loan association are matters dealing with the internal affairs of the association. Thus, as the *Murphy* court stated, a state court adjudicating in this area would have to apply federal common law rules rather than the laws of its own state." *City Federal Savings & Loan Ass'n v. Robert P. Crowley, Sr., et al.*, ... F. Supp. ...., Civil Action No. 72-C-501

(U.S.D.C. E.D.Wis., filed April 24, 1975) (Slip opinion, pp. 20-21).[3]

In the same tone, the U.S. District Court for the Northern District of Illinois held as follows within the last few weeks:

> "Federal savings and loan associations are instrumentalities and agencies of the United States, *United States v. Harper*, 241 F.2d 103 (7th Cir. 1957); *First Federal Savings and Loan Ass'n v. Loomis*, 97 F.2d 831 (7th Cir. 1938), created as part of a nationwide network of mutual thrift institutions to provide a safe place for people to invest their money and to acquire financing for homes. These federal associations are chartered by the Board in accordance with the HOLA, 12 U.S.C. §1461 et seq. which authorizes the Board, 'under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation and regulation of such institutions.' Pursuant to this authority, the Board has promulgated comprehensive rules and regulations, 'covering all aspects of every federal savings and loan association from its cradle to its corporate grave.' *Kupiec v. Republic Federal Savings and Loan Association*, No. 74-1835, slip opinion at 2 (7th Cir. decided March 4, 1975) citing *Meyers v. Beverly Hills Federal Savings & Loan Ass'n*, 499 F.2d 1145, 1147 (9th Cir. 1974).
>
> "By virtue of the plenary powers vested in the Board by the HOLA, the courts have consistently recognized the congressional intent to have federal law govern the regulation and supervision of federal associations. *Lyons Savings and Loan Association v. Federal Home Loan Bank Board*, 377 F. Supp. 11, 17 (N.D. Ill. 1974); *People v. Coast Federal Savings & Loan Association*, 98 F. Supp. 311 (S.D. Cal. 1951). The cases

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[3]Copies of all unreported decisions referred to herein are being sent to the Court and counsel for the parties under separate cover.

are legion which hold that this preemptive delegation of authority to the Board extends to the internal operations of these institutions, precluding any regulation or interference by the states [citations omitted].

"To the extent either that the Board's formal policy statements covering conflict of interest and corporate opportunity were effectuated after the defendant directors and officers allegedly began violating their fiduciary obligations to the associations, or that the policy statements do not cover all aspects of the subject matter, defendants assert that the court must fashion and apply federal common law. The consistency and universality inherent in applying a single federal standard to the federal savings and loan system, whether it be statutory, regulatory or derived from federal common law, is in keeping with the underlying objective of the HOLA, which contemplates a uniform set of policies for federally chartered associations which does not vary with quirks of local law. *Murphy v. Colonial Federal Savings & Loan Association, supra; North Arlington National Bank v. Kearney Federal Savings & Loan Ass'n.*, 187 F.2d 564 (3d Cir. 1951) *cert. denied*, 341 U.S. 816; *California v. Coast Federal Savings & Loan Ass'n., supra*. Even as a policy matter, it is clearly preferable to have federal law apply to the management practices of federally chartered associations.

"Since only the Board may regulate or supervise the internal affairs of the defendant associations precluding any state interference and the fiduciary duties of directors and officers of federal savings and loan associations are matters relating to the internal affairs of the associations, *City Federal Savings and Loan Association v. Crowley, supra* at 21, only federal law may be applied to questions involving them. *Murphy v. Colonial Federal Savings & Loan Association, supra; City Federal Savings and Loan Association v.*

Crowley, supra. This is true even where the directors' conduct is not specifically proscribed by any specific regulation of the Board. In such a case, the court may rely upon federal common law to fill out the framework of the Board's regulatory scheme." *Rettig v. Arlington Heights Federal Savings & Loan Ass'n.*, ... F. Supp. ...., Civil Action No. 74 C 3151 (U.S.D.C. N.D. Ill., filed July 2, 1975) (slip opinion, pp. 7-8, 12-14).

In view of the foregoing, when the Board issues a regulation dealing specifically with a particular aspect of the operation of Federal associations, that regulation constitutes "Federal law", since a Board regulation has the full force and effect of law when applied to Federal savings and loan associations. See, *e.g., Community Federal Savings & Loan Ass'n v. Fields*, 128 F.2d 705, 707 (C.A. 8, 1942); *California v. Coast Federal Savings & Loan Ass'n, supra*, 98 F. Supp. at 316; *Woodward v. Broadway Federal Savings & Loan Ass'n of Los Angeles*, 244 P.2d 467, 470-71 (Dist. Ct. of App., 2nd Dist. Cal. 1952).

In the situation at issue herein, the Board does not have a regulation dealing specifically and exclusively with "due on sale" clauses in the loan instruments of Federal savings and loan associations. However, the Board's staff does conduct annual examinations of Federal associations pursuant to this agency's statutory authority under 12 U.S.C. 1726(b) and 1730(m)(1) and (2). An essential part of such examinations is an inspection of the loan documents being used by Federal associations. Thus, for many years the Board and its staff have been fully aware that Federal associations throughout the Nation were following the practice of using "due on sale" clauses in their loan instruments, and have

approved and publicly sanctioned such use.[4] This, in the Board's view, when taken in conjunction with the pervasive regulatory scheme in the Board's Federal Regulations and particularly in conjunction with § 545.6-11 of those regulations (discussed below), constitutes sufficient regulatory action to preempt the field. For as the United States Supreme Court held in *Bethlehem Steel Co. v. New York State Labor Relations Board,* 330 U.S. 767, 773-774 (1947):

> ". . . When Congress has outlined its policy in rather general and inclusive terms and delegated determination of their specific application to an administrative tribunal, the mere fact of delegation of power to deal with the general matter, without agency action, might preclude any state action if it is clear that Congress has intended no regulation except its own. . . .

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[4]The Board, in its past public statements, has strongly opposed the elimination of "due on sale" clauses. For example, in a March 17, 1975, speech before the Legislative Conference of the National Association of Realtors, the former Chairman of the Board stated:

> "A due-on-sale clause prohibition says that a loan can stay on a house even after the borrower has sold the house. The loan is probably at a low rate, if it is not paid off. At first blush, that sounds pretty good. But looking a little closer, this does two things. First, it allows the selling borrower to increase the price of his house which has the low rate loan and produce a windfall. And he does this at the expense of the saver [of the lending institution] who can't get paid a competitive rate due to the low rates on such mortgages.
>
> "The follow-up to that is that savers won't tolerate that and so to get the income to keep the savings, the S&L must invest in another state or in some other kind of asset. There is no choice. Money is drawn right out of your housing market and homebuyers in need don't even have a chance. When the full story is in, it doesn't look very nice at all.
>
> "If that isn't enough, the loans that are made in such states have limited, if any, marketability. Usury states in many instances have no access to the secondary market for mortgages and the increased supply of housing credit it makes available. The result will likely be the same if the due-on-sale clause is destroyed. It will deny or seriously jeopardize any secondary market acceptance of these loans."

> *But when federal administration has made comprehensive regulations effectively governing the subject matter of the statute, the Court has said that a state regulation in the field of the statute is invalid even though that particular phase of the subject has not been taken up by the federal agency. . . .*" (Emphasis added.)

The Board's governing statute, obviously, satisfies the above criteria. As the Third Circuit put it in *North Arlington, supra:*

> "The statute [HOLA] is one of the type which states a policy, provides for the project under consideration, lays down some general rules and prohibitions *and leaves details to the Board. . . .*" (187 F.2d at 565) (Emphasis added.)

And both the Ninth Circuit, the Seventh Circuit and this Court have held that the Board has issued "comprehensive regulations" governing the entire subject matter of the HOLA. See *Meyers, Kupiec* and *Coast Federal, supra.*

In particular, the Board has had a regulation in effect since 1948 which specifically requires that each "loan contract" of a Federal savings and loan association "shall provide for *full protection* to the Federal association." (12 CFR 545.6-11 (1975)) (emphasis added). The Board has construed 12 CFR 545.6-11 — and by this Advisory Opinion still so construes that regulation — as authorizing "due on sale" clauses for Federal associations (regardless of any State law to the contrary) because, for the reasons set out in Part II of this Opinion, *infra,* such clauses "provide for full protection to the Federal association."

Where a Board regulation, such as 12 CFR 545.6-11, grants a right or imposes a duty in "general" terms respecting Federal associations or their members, any issue concerning such rights or duties must be resolved exclu-

sively under Federal law. See *Murphy, supra,* 388 F.2d at 611 (". . . an issue, which requires a fleshing out of the Board's regulations, is one of federal law. . ."); and *Kupiec, supra,* 512 F.2d at 152. Therefore, to the extent that there may be gaps in the general subject matter encompassed by the Board's regulations, they must be "fleshed out" by Federal law in one of two ways. The Board may close the "gap" by the promulgation of additional regulations, the adoption of Board Rulings or Policy Statements, or by the issuance of interpretive opinions, such as this Advisory Opinion. Alternatively, to the extent that the Board does not take such specific formal action, it will be necessary for the courts to resolve the matter by applying or fashioning *Federal common law.*

When "fashioning" Federal common law, the Court should give considerable weight to the Board's interpretation of its own regulations[5] and, if necessary, the Court also may look to State law for guidance.

With respect to the latter point, in *Murphy, supra,* the Second Circuit indicated that when fashioning "federal common law", Federal courts could look to principles of law which have "achieved . . . widespread recognition" in many States, rather than looking to the law of the jurisdiction where the case arose (388 F.2d at 612, n. 2). In this connection, the Board notes that the majority of courts in the United States have upheld the validity of "due on sale" clauses. *See, People's Savings Association v. Standard In-*

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[5]See, *e.g., Udall v. Tallman,* 380 U.S. 1, 16-17 (1965); *Bowles v. Seminole Rock & Sand Co.,* 325 U.S. 410, 413-414 (1945); *FDIC v. Sumner Financial Corp.,* 451 F.2d 898, 902 (C.A. 5, 1971). The courts have given substantial deference to the Board's interpretation both of its own regulations, and those issued by the Board as the operating head of the Federal Savings and Loan Insurance Corporation. See *Kupiec, supra,* 512 F.2d at 151; *Michals v. Federal Savings and Loan Insurance Corporation,* 413 F.2d 144, 147 (C.A. 7, 1969).

dustries, Inc., 22 Ohio App.2d 35, 257 N.E.2d 406 (1970); *Shalit v. Investors Savings & Loan Ass'n*, 244 A.2d 151 (N.J., 1968); *Stith v. Hudson City Savings Institution*, 63 Misc.2d 863, 313 N.Y.S.2d 804 (Supp. Ct. 1970); *Gunther v. White*, 489 S.W.2d 529 (Tenn. 1973); *Malouff v. Midland Federal Savings and Loan Association*, 509 P.2d 1240 (Colo. 1973); *Baker v. Loves Park Savings and Loan Association*, ... N.E.2d ...., No. 46999 (Illinois Supreme Court, June 2, 1975); *Stockman v. Burke*, 305 So.2d 89 (Fla. Ct. App. 1974); *but see, Baltimore Life Insurance Company v. Harn*, 15 Ariz. App. 78, 486 P.2d 190 (1971) (refusal to allow the operation of a "due on sale" clause, noting that the mortgagee, in attempting foreclosure, did not allege that the security would be jeopardized by sale of the collateral); *Walker Bank & Trust Company v. Neilson*, 26 Utah2d 383, 490 P.2d 328 (1971) (the Utah Supreme Court held that the "due on sale" clause at issue, while not a per se violative of public policy, could not be enforced as it was not self-executing and the bank did not specifically elect to accelerate the maturity of the loan under the "due on sale" clause in its note); *Tucker v. Pulaski Federal Savings & Loan Association*, 481 S.W.2d 725 (Ark. 1972) (Refusal to allow operation of a "due on sale" clause because mortgagee did not have a valid business reason for withholding its consent requisite to a sale of the security property).

There is an additional reason for applying Federal law. It is clear that there must be uniform regulations or standards for Federal savings and loan associations. See, *e.g.*, *Springfield Institution for Savings v. Worcester Federal Savings & Loan Ass'n*, 329 Mass. 184, 107 N.E.2d 315, 318 (1952), *cert. denied*, 344 U.S. 884. This is the public policy reason why State law generally is not applicable to Federal asso-

ciations. As pointed out by this Court in *Coast Federal, supra,* (98 F. Supp. at 319):

> ". . . The congressional mandate for uniformity would be destroyed if these associations [Federal savings and loan associations] were subject to federal control, plus concurrent state control, which latter control might vary in every one of the forty-eight states."

Moreover, in *Murphy, supra,* the Second Circuit fashioned and applied Federal common law — not State law — to the issue of whether depositors of a Federal association were entitled to the association membership list, and in so doing observed (388 F.2d at 611):

> ". . . Congress could hardly have intended that the rights of members of federal savings and loan associations to fair elections should vary with quirks of local law."[6]

By the same token, a uniform rule is required for the exercise of "due on sale" causes for Federal associations, because, as the Board shows, *infra,* the elimination of such clauses will have an adverse affect [sic] on the earning power and financial stability of Federal associations, will impair the ability of Federal associations to sell their loans in the secondary markets, will reduce the amount of home-financing funds available to potential home buyers, and generally will cause a rise in home loan interest rates. The Board notes that the plaintiff, himself, agrees that there is

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[6]We are discussing here only Board regulation and control over the affairs, business, business powers and authority, internal and external expansion, supervisory matters, internal operations and affairs, relationships between the association, its management and its members, and all similar and related matters respecting Federal associations. The Board does not seek to regulate wholly unrelated matters of purely local concern, such as zoning for Federal association property, methods for recording title, etc., which are left by the Board to State and local authorities, since they do not impinge upon the regulatory areas under Board control, or interfere with the Board's overall regulatory scheme.

a necessity for a National uniform rule respecting the exercise of "due on sale" clauses (Opening Zamos Affidavit, p. 8).

There is one last rationale as to why Federal law is applicable to this controversy. The cases cited above uniformly hold that Federal law exclusively governs the "internal affairs" of Federal associations. There are two reasons why this controversy involves an internal affair of Mission Federal. *First*, all borrowers from a Federal association are "members" of the association, and are entitled to vote and otherwise participate in the association's affairs. *Kupiec, supra*, 512 F.2d at 152-153. Thus, the power of the Eimers to sell the property securing their loan from the association is a matter involving the rights of the Eimers as borrowing members of Mission Federal vis-a-vis the rights of the association, its saver members, and its other borrowing members. *Second*, paragraph 7(f) of Mission Federal's bylaws (which are themselves uniform bylaws prescribed by the Board as part of its pervasive regulatory scheme) gives the association's Board of Directors authority to reject any "membership" in the association. Therefore, the right of Eric Schott to become a borrowing member of Mission Federal by assuming the Eimer loan clearly constitutes an internal affair of the association.

Finally, even if the Court were to accept the plaintiff's views as to Federal preemption, State law — if it operated to invalidate "due on sale" clauses — would, nevertheless, not be applicable to Federal associations. In this respect, plaintiff states that:

> ". . . . [F]ederal savings & loan associations are subject *only* to such state regulation as does not interfere with the purpose for which they were created, does not destroy their efficiency, and does not conflict with

paramount federal law." (Plaintiff's Memorandum, p. 6) (Emphasis added.)[7]

However, as shown *infra*, State law — to the extent it operates to invalidate "due on sale" clauses — would "destroy" the "efficiency" of Federal associations, and would "interfere" with a principal purpose for which Federal associations were created, namely, making the maximum number of home loans to credit-worthy borrowers at the lowest interest rates possible under prevailing money market conditions.

For the foregoing reasons, it is the Board's opinion that Federal law exclusively governs the pending controversy between the parties.

II

THE FUNDAMENTAL ECONOMIC AND MARKETING CONSIDERATIONS UNDERLYING THE USE OF "DUE ON SALE" CLAUSES

A. The Reasons for the "Due on Sale" Clause.

There are three commonly assigned reasons underlying the exercise of "due on sale" clauses. Such clauses enable the lending savings and loan association to —

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[7]Plaintiff also contends that Federal preemption is not applicable here because 12 U.S.C. 1464 (a) requires the Board, in issuing charters for Federal associations, and in adopting regulations respecting such associations, to give primary consideration to the best practices of local thrift institutions (Plaintiff's Memorandum, p. 5). However, the courts have consistently construed 12 U.S.C. 1464(a) as empowering the Board to authorize such practices for Federal associations which the Board deems advisable — even where State law is to the contrary. See *Lyons, supra*, 377 F. Supp. at 17-18; *Central Savings, supra*, 293 F. Supp. at 621-622, *aff'd*, 422 F.2d at 506.

The Board finds that the other statutes and regulations cited at pp. 5-6 of Plaintiff's Memorandum are wholly inapposite to the Federal preemption issue involved in the subject lawsuit.

(1) ensure that the real property securing its loan is not sold, subject to its loan, to a person of doubtful financial stability, and to assure that its loan is not assumed by a new purchaser who the association does not consider to be credit-worthy;

(2) adjust its loan portfolio towards current market rates, thus safeguarding and protecting the financial stability of the association and permitting it to make new home loans at lower interest rates than otherwise would be necessary to maintain an adequate yield on its mortgage portfolio; and

(3) sell its existing home loans in the secondary mortgage market in an orderly manner, thereby generating substantial new funds for additional residential loans, which otherwise would be unavailable.

The plaintiff contends that only the first purpose listed above is a valid reason for the association to exercise its "due on sale" clause. In its Complaint in this lawsuit (p. 6), the plaintiff alleges that a savings and loan association's —

> ". . . sole right under a 'due on sale' clause is to review and approve the credit of a prospective purchaser of property subject to a Deed of Trust, assure itself that its security interest in the property subject to such Deed of Trust is not in jeopardy and charge a reasonable processing fee based upon the actual time and expenses incurred in reviewing an application for consent."

The parties agree that Mission Federal's security interest in the subject property will not be placed in jeopardy by the assumption of the Eimer loan by Eric Schott, *provided* that David Schott (his father) acts as guarantor. Therefore, the

remainder of this Part will be addressed to the second and third reasons for the exercise of "due on sale" clauses.[8]

B. The "Due on Sale Clause is Vital and Necessary to Enable Savings and Loan Associations to Adjust their Loan Portfolios Towards Current Market Rates, thereby Protecting Associations' Financial Stability and Enabling them Generally to Make New Home Loans at Lower Interest Rates than Otherwise Would Prevail.

Federal savings and loan associations in California, like those throughout the rest of the Nation, generally obtain their funds from short-term sources,[9] and invest them primarily in long-term real estate loans, which ordinarily have terms between 25-30 years in the case of single-family dwelling units. The difficult problem of borrowing short and lending long has been aggravated by the fact that in the post-war years the cost of funds to savings and loan associations, on balance, has been constantly increasing, and savings and loan associations, even in the best of years, typically operate on a very thin margin of profit (Pratt Report, Table 5).[10]

In periods of rising interest rates, as has been the case, on balance, during recent years, the cost of funds to savings

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[8]The Board notes, however, that some courts have held that the need to protect the "lender's security interest" justifies a *per se* exercise of a "due on sale" clause without regard to the "circumstances of each particular case." See, *e.g.*, *Baker v. Loves Park Savings and Loan Association*, ... N.E.2d ...., No. 46999 (Illinois Supreme Court, June 2, 1975) (slip opinion, p. 4).

[9]Such short-term sources consist of passbook savings accounts (which, in practice, are subject to immediate withdrawal); certificate savings accounts (with fixed terms of maturity from 3 months to 6 years); and advances from the Federal Home Loan Bank System.

[10]Professor Pratt points out that the average net margin of profit per $100 investment in home loans was only $0.21 per annum for the years 1965-1973 for savings and loan associations in California, Arizona and Nevada (Pratt Report, Table 5).

and loan associations has increased faster than their average loan portfolio yields. In this respect, the Board's economists have observed:

> "However, it is likely that at least a few times in the future, mortgage rates will increase. At such times, S&Ls' costs of funds will be typically rising as well (sometimes faster than current mortgage rates). Table 1 shows that when mortgage rates increase, the average portfolio yield increases only slowly, and that it increases even less rapidly the longer the term to prepayment. The consequence is that when interest rates are rising, S&Ls' cost of funds are increasing much faster than are portfolio yields, causing reduced or even negative earnings. If interest rates remain high or keep rising, the consequences could be severe, such as insolvency. If the rise is only temporary, mortgage flows are curtailed, and mortgage rates rise as a consequence." (OER Opinion, p. 3).

One of the chief means employed by savings and loan associations to reduce, at least in part, the serious problems caused by the rising costs of their funds is the exercise of "due on sale" clauses. This enables the association, during periods of rising interest rates, to eliminate low-yield loans from its loan portfolio, and to replace them with higher-yield loans in line with the market rates existing at the time the original borrowers sell the real property securing their loans.

The parties agree that the vast majority of home loans made by savings and loan associations in California presently are repaid long before their maturity. The plaintiff states that: ". . . it is a well known fact that the average loan in the State of California is paid off in full somewhere between the 5th to 10th year of the loan life, so that notwithstanding the original thirty year maturity date, it is a rare loan that stays on the savings & loan's books in excess

of ten years" (Opening Zamos Affidavit, p. 7). Professor Pratt states that half of the conventional mortgages originated by a savings and loan association in a given year will be repaid in full well within ten years (Pratt Report, p. 12).[11] In the case of Mission Federal, its home loans have "an average life of approximately 8 years" (Coulson Affidavit, p. 51).

The Board does not believe that elimination of the "due on sale" clause would result in the assumption of all loans which presently are being repaid upon the sale of the property securing the loan. As pointed out by the California Association of Realtors, a new purchaser often will lack the necessary financial resources to assume a loan (even if it has a low interest rate) which is 7-10 years old, and is on a house whose market value has escalated by almost 10% per year (California Realtors Statement, pp. 2-3). However, the Board fully agrees with the following conclusion of its staff economists:

> "Without the due on sale clause, there are likely to be more assumptions of existing mortgages. It is likely, as pointed out by Pratt, that 'wraparound' financing will become prevalent, implying that even on houses whose market value has increased substantially, existing mortgages are likely to be assumed if their rate is below the current mortgage rate.
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> "Thus, the likely impact of universal (or statewide) assumable mortgages is a lengthening of the life expectancy, or prepayment period, of mortgages. . . ." (Opinion of OER, p. 2).

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[11]Professor Pratt's statement is based upon a study commissioned by the Federal Home Loan Mortgage Corporation entitled "An Empirical Analysis of Mortgage Prepayments", by Maurice E. Kincade, Ph.D. Dissertation, University of Utah, pp. 49, 51.

Thus, it appears likely that Federal savings and loan associations will suffer adverse financial consequences if only a portion of the low-yield loans, presently being paid off in full upon the sale of the security property, are assumed because of elimination of the "due on sale" clause.

For example, Professor Pratt makes the point that since 1967 savings and loan associations (because of the increasing cost of funds) have been losing very substantial amounts of money on home loans made during 1965 at the average interest rates then prevailing (Pratt Report, Table 1). Such loss has been reduced partially *only* because associations, by means of the "due on sale" clause, have been able to replace the low-yield 1965 loans with higher yield loans upon the sale of the security property.[12]

Professor Pratt also gives the following example (which is admittedly extreme) of the potential adverse affect that elimination of the "due on sale" clause could have on the earnings of savings and loan associations:

> "Table 4 provides a comparison of two hypothetical mortgages [in the amount of $10,000], one subject to a due on sale clause, the other not having the due on sale clause. Both are assumed to be closed December 31, 1964, and the property subsequently sold December 31, 1968, and again December 31, 1971. Loans closed December 31, 1964, are assumed to be at an interest rate of 6%, essentially the national mortgage rate existing at that point in time. Upon sale of prop-

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[12]Professor Pratt points out that savings and loan associations in California, Arizona and Nevada — on the average — during 1973 sustained a loss of 56 cents per every $100 invested in home loans during 1965 (Pratt Report, Table 1). The figures given in the Pratt Report, if projected, indicate that an association which had made a $25,000 home loan in 1965 at the average prevailing interest rate in the Western States would have sustained a net loss of $350 on the loan if it still held the loan at the end of 1973.

erty, December 31, 1968, the loan having the due on sale clause is called, and the interest rate raised to the current rate of 7% existing in 1968. This results in a new monthly payment of $69.93. When the property is sold December 31, 1971, the due on sale clause is again invoked, and the interest rate raised to 7.75%, again the current lending rate. By invoking the due on sale clause, the total payments received from this loan over the 25 year period amount to $21,538, whereas the total payments received from the loan not having the due on sale clause amount to $19,329. The loss from removal of the due on sale clause amounts to $2,209, approximately 22% of the original amount of the mortgage loan.

"In the absence of the due on sale clause, the mortgage lender would have had to charge a rate to the original borrower of approximately 7%, instead of the actual 6% rate originally charged." (Pratt Report, pp. 20-21; Emphasis added.)

The courts have recognized that the need for savings and loan associations to adjust their loan portfolios towards current market rates constitutes a valid and lawful reason for the exercise of "due on sale" clauses.

For example, in *Malouff v. Midland Federal Savings and Loan Assoc.*, 509 P.2d 1240, 1244-45 (Colo., 1973), the Colorado Supreme Court, in upholding a lender's reliance on an acceleration on sale clause to obtain an increase in the interest rate on an assumed loan, held as follows:

"We hold the due-on-sale clause here to be a reasonable restraint on alienation. The question then remains, what conditions may be imposed on an assuming purchaser in return for non-exercise of the clause? In Cherry v. Home Savings and Loan Association, *supra*, an analogous situation to that in the present case was considered. It was there held to be a justifiable

interest of the lender to protect itself against a rise in the interest rate and to permit an acceleration of the indebtedness on sale where the purchaser will not agree to pay an increased interest rate on assumption of the loan. The restraint on alienation by the election to exercise the due-on-sale clause under these circumstances was held to be a reasonable one and enforceable . . .

* * *

". . . This evidence, not in dispute, demonstrated that the imbalance between the loan demand and the money supply, arising out of an inflationary economy, required that Midland, as well as similar lending institutions, adopt measures which would protect the borrowers as well as the lenders from the hazards of long term loans (20-30 years) at fixed interest rates. . . .

* * *

"We do not consider the motive of Midland in seeking to protect itself and the borrower from the effects of inflationary or deflationary conditions in the money market to be improper or unlawful. Both parties have the benefit of their original bargain during their continued creditor/debtor relationship. However, when the property is sold to a purchaser who desires to assume the existing loan, economic consideration may reasonably justify the lender in raising the interest rate to or approaching one equal to the current market rate. We view the condition imposed for the non-exercise of the acceleration clause under such circumstances to be a reasonable protection of a justifiable interest and the operative effect of the clause does not therefore constitute an invalid restraint on alienation."

Similarly, the Tennessee Supreme Court, in the case of *Gunther v. White*, 489 S.W.2d 529, 531-32 (Tenn., 1973), held:

"It is generally accepted that a court of equity has the power to relieve a mortgagor from the effect of an operative acceleration clause in a mortgage where the condition making the option operative is the result of some *unconscionable or inequitable* conduct of the mortgagee . . .

"No case has been found, however, which holds that the exercise of the option to gain the benefit of a current interest rate falls into these categories. And, upon reflection, we can think of no reason why such exercise should be characterized as either unconscionable or inequitable. Although interest charges are subject to strict regulation and to that end we have both constitutional and statutory provisions in regard thereto, Constitution of the State of Tennessee, Article XI, Section 7; Section 47-14-104 T.C.A., interest charges which are within the constitution and the statutes are valid. And, although some savor the subject of interest with a grimace, because of its too frequent association with usury, acts related to securing a current lawful rate of interest are neither unconscionable nor inequitable.

* * *

"Finally analyzed, the situation here is simply that appellants can sell their property at a higher price if they sell it at the lower interest rate. *The appellees under their contract have the right to insist upon the repayment of their loan in the event of sale, so that they can relend the money at an increased interest rate, and so maintain their supply of lending money, at the level of their present cost of such money.* In this situation, equity should not depart from the law which requires it to enforce valid contracts and strike down the acceleration option simply because its exercise will let the appellees, not the appellants, make the profit

on the interest rate occasioned by the increased cost of money."[13] (Emphasis added.)

For the foregoing reasons, the Board believes that the need of an association to adjust its loan portfolio to current market rates fully justifies the exercise of a "due on sale" clause, either by requiring the original borrower to repay the loan in full upon the sale of the security property, or insisting that the new purchaser assume the existing loan at an increased interest rate in line with prevailing market rates. The elimination of the "due on sale" clause will, in the Board's view, endanger the financial stability of the association, and generally require it to charge higher interest rates on home loans across-the-board to compensate for its substantial loss of earnings directly resulting from elimination of its right to accelerate.

The Board also recognizes that elimination of the "due on sale" clause will impact to some extent State savings and loan associations in California. However, such impact will be minimized by the fact that State associations are empowered to offer, and they presently are offering, variable rate mortgage loans, and they also are empowered to make short-term, roll-over loans on single-family homes. Federal associations, however, generally are prohibited from making similar short term loans, and they presently may not make variable rate mortgage loans (12 CFR 545. 6-1, 545.6-3 and 545.14). Thus, the Board is seriously concerned not only with the direct adverse consequences to Federal associations in California from eliminating the

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[13]The Board does not regard California law to be to the contrary in the situation of an outright sale of the security property. In *Tucker v. Lassen Savings & Loan Ass'n*, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974), the California Supreme Court did not accept the rationale of the *Malouff* and *Gunther* cases as being applicable to an installment land contract, but it specifically reserved the question of the applicability of such rationale to an outright sale. 116 Cal. Rptr. at 639-40, n. 10.

"due on sale" clause, but also the indirect consequences resulting from such elimination which could alter the competitive equality between Federal and State associations.

The Board has applied the foregoing principles to the controversy between Eric Schott and Mission Federal. Mission Federal, in addition to its passbook savings, has obtained 56% of its savings funds from certificate accounts, which have an average maturity of approximately two years, and which pay an average rate of interest substantially in excess of 6% per annum (Coulson Affidavit, p. 52). Obviously, this association has a high cost of funds, and it has a corresponding compelling need to adjust its loan portfolio to current market rates, since it obtains 85.5% of its income from its loan portfolio (Coulson Affidavit, p. 55). Thus, the exercise of the "due on sale" clause is essential to the association, since it makes home loans for terms of 25-30 years, which have an average life of only 8 years (Coulson Affidavit, p. 51). By virtue of interest adjustments on assumptions of loans at current market rates during the last six months of 1974, alone, the association increased the value of its loan portfolio by $170,000 (Defendants' Presentation, pp. 66-67). The Board believes that the loss of any significant portion of this increase (and past increases) would have been injurious to the financial stability of the association, and may have required an increased interest rate on new loans.

Therefore, the Board's position is that Mission Federal's requirement that Eric Schott assume the Eimer loan at an increased interest rate (¼ of 1% below the prevailing market rate) was valid and proper in all respects.

C. The "Due on Sale" Clause is Necessary so that Associations Can Sell Their Loans in the Secondary Mortgage Market in an Orderly Manner, Thereby Generating Substantial New Funds for Additional Residential Loans which Otherwise Would be Unavailable.

The most immediate and direct adverse secondary mortgage market impact resulting from invalidation of the "due on sale" clause is the likely elimination of Federal associations in California from participating in the residential loan purchase program of the Federal Home Loan Mortgage Corporation ("FHLMC").

FHLMC is a corporate instrumentality of the United States (whose board of directors consist of the three Members of the Federal Home Loan Bank Board, 12 U.S.C. 1452), which was established by Congress, in 1970, for the purpose, among others, of purchasing, and making commitments to purchase, residential mortgages and deeds of trust from any Federally-insured financial institution, or any financial institution which is a member of the Federal Home Loan Bank System (12 U.S.C. 1454(a)(1)).

During the period from January 1, 1972 through July 4, 1975, FHLMC purchased 31,493 conventional deeds of trust secured by residential property in California, having an aggregate principal balance in excess of $933 million at the time of FHLMC's purchase (additional conventional loans were purchased by FHLMC in 1970 and 1971 but a breakdown by States is not available). The $933 million paid by FHLMC for California deeds of trust has been channeled directly back into California home loans. FHLMC requires every selling financial institution to warrant that for each dollar amount of loans purchased by FHLMC from the seller, the seller will advance or commit an equal amount

in residential loans within 180 days of the purchase contract date of funding by FHLMC.

FHLMC, shortly after its establishment in 1970, drafted, for use in its Nationwide purchase program, uniform note and mortgage (or deed of trust) instruments. The "due on sale" clause was included in such uniform forms because FHLMC found that such clause existed in over two-thirds of the conventional mortgage forms surveyed (principally those used by savings and loan associations), and because there was strong support for such clause at the three days of public hearings held in connection with the form drafting process. The FHLMC, after considering both lender and consumer comments, concluded that a "due on sale" clause was necessary, among other reasons, because: (1) it helps a mortgage lender to keep his overall portfolio yield more closely in line with general money market conditions and the costs of his funds; and (2) it eases inflationary pressures for higher interest rates on loans to new borrowers since older, low-yield loans are retired more quickly — thereby reducing the need for offsetting higher rates on current loans.

Recently FHLMC and the Federal National Mortgage Association ("FNMA") have adopted joint uniform loan documents, which will go into effect on January 1, 1976, that must be used by all financial institutions which sell their residential loans to FHLMC or FNMA. The uniform deed of trust to be used by FHLMC and FNMA in California contains the following standard provision:

> "17. *Transfer of the Property; Assumption*. If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent, excluding (a) the creation of a lien or encumbrance subordinate to this Deed of Trust, (b) the creation of a purchase money security interest for household appliances, (c) a transfer by devise, descent

or by operation of law upon the death of a joint tenant or (d) the grant of any leasehold interest of three years or less not containing an option to purchase, Lender may, at Lender's option, declare all the sums secured by this Deed of Trust to be immediately due and payable. Lender shall have waived such option to accelerate if, prior to the sale or transfer, Lender and the person to whom the Property is to be sold or transferred reach agreement in writing that the credit of such person is satisfactory to Lender and that the interest payable on the sums secured by this Deed of Trust shall be at such rate as Lender shall request. If Lender has waived the option to accelerate provided in this paragraph 17, and if Borrower's successor in interest has executed a written assumption agreement accepted in writing by Lender, Lender shall release Borrower from all obligations under this Deed of Trust and the Note.

"If Lender exercises such option to accelerate, Lender shall mail Borrower notice of acceleration in accordance with paragraph 14 hereof. Such notice shall provide a period of not less than 30 days from the date the notice is mailed within which Borrower may pay the sums declared due. If Borrower fails to pay such sums prior to the expiration of such period, Lender may, without further notice or demand on Borrower, invoke any remedies permitted by paragraph 18 hereof."[14]

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[14]The plaintiff seeks to distinguish between the joint FHLMC/FNMA "due on sale" clause and the one used by Mission Federal. Plaintiff argues that while the forms used by FHLMC "contain a due on sale provision, such form specifically sets forth in the clause that it is subject to an interest rate adjustment upon sale", and no similar provision is contained in Mission Federal's loan forms (Zamos Reply Affidavit, p. 6). The Board cannot agree with the plaintiff's contention in this regard. The joint FHLMC/FNMA form merely gives the lender the *option* of accelerating the maturity of the loan, *or* waiving his option by agreeing to the credit of the new purchaser and also agreeing to the assumption at an increased interest rate satisfactory to the lender. By the same token, since Mission Federal has an *unqualified* right to accelerate the maturity of its loan upon sale of the security property, it, necessarily, has the *lesser* right of waiving its power to accelerate by allowing an assumption of the loan by a new purchaser whose credit is acceptable to Mission Federal, and who agrees to an increased interest rate satisfactory to the association.

In view of the foregoing, the Board is seriously concerned that invalidation of the "due on sale" clause would eliminate Federal associations in California from participation in the residential loan purchase program of FHLMC and FNMA, thereby substantially reducing the flow of additional home loan funds into California.[15]

The Board is equally concerned that striking down the "due on sale" clause also might have an adverse impact on the purchase of California residential deeds of trust by FHLMC and FNMA on behalf of the Government National Mortgage. Association ("GNMA"). In this connection, Congress, pursuant to the Emergency Home Purchase Assistance Act of 1974, authorized GNMA to spend $7.75 billion for the purchase of mortgages and deeds of trust. To implement such authorization, GNMA has contracted with FHLMC and FNMA for the latter two corporations to purchase — on behalf of GNMA — $5 billion in residential mortgages and deeds of trust. FHLMC and FNMA already have purchased $3 billion in such loans for GNMA, and they presently are in the process of purchasing the remaining $2 billion. It is significant, that GNMA has allocated a minimum of 13% of the $5 billion for the purchase of California residential deeds of trust. Furthermore, under the 1975 Emergency Housing Act (which recently has been signed into law by the President) GNMA has been authorized to purchase an additional $10 billion in residential loans. Assuming GNMA administers its new purchase program in the same fashion that it has administered its past programs under the Emergency Home Purchase Assistance Act of 1974, nearly $1 billion may be allocated for the purchase of California residential deeds of trust (there is no

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[15]Since January 1, 1973, FNMA has purchased approximately $466 million of California deeds of trust.

assurance, of course, that GNMA will administer its new program in the same manner as it did its previous programs, or that the entire $10 billion will be spent).

There is another serious impact eliminating the "due on sale" clause that relates to private secondary mortgage market transactions. Professor Pratt sums up this problem as follows:

> "The secondary loan purchaser . . . has certain understandings concerning the investment which he is purchasing. Loans are normally purchased based on an assumed life of 12 years. If maturities of California loans are lengthened as a result of a legally imposed change in the due on sale clause, the California loan will become an inferior product of questionable salability in national markets.
>
> "A mortgage loan originated at 8 per cent interest which must be sold to yield 9 per cent will sell at a price based on an expected life of 12 years. This would result in a sale price of $9,307.10 [for a $10,000 loan]. If the purchaser were to assume that the loan would remain on the books for the full 360 months with no prepayment, the price for $10,000 of unpaid balance would be $9,119.80, a difference of $187.30, or 1.87 per cent of the unpaid balance. Elimination of the due on sale clause would either make it impossible for the California loans to trade competitively with loans from other states having the due on sale clause, or would cause California loans to sell at a discount relative to other states." (Pratt Report, pp. 24-25).[16]

The Board's economists have expressed views on this matter similar to those of Professor Pratt; they state:

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[16]The secondary mortgage market is of major importance to the State of California. Professor Pratt observes that 36% of the single-family residential deeds of trust in the Western States are held by lenders outside of the region (Pratt Repor , pp. 23-24).

"Given a choice between a mortgage with a due on sale clause and on one without it, both at the same contract rate, a purchaser in the secondary market would select the one with the due on sale clause. Stated another way, the rate must be higher on the mortgage without the clause than on the one with it in order to interest the purchaser. . . .

"As mentioned above, one of the effects of the lack of a due on sale clause is to reduce the expected maturity of mortgages. This fact, in and of itself, implies a lower return on mortgages selling below par. For example, an 8-percent, 25-year mortgage that is selling at 98 would yield 8.36 percent if it were anticipated that its effective maturity is 8 years, but its yield is reduced by 12 basis points to 8.24 if its effective maturity were anticipated to increase to 20 years because the due on sale clause is excluded. Looked at another way, to keep the yield at 8.36, the price would drop from 98 to 97.

"However, this yield differential does not account for the income foregone by not turning over the investor's money into a higher yielding instrument in the eighth year as opposed to waiting until the twentieth year. Also, the market expectations embodied in the price of 98 must incorporate a level as opposed to a fluctuating mortgage rate forecast. It also does not account for the potentially higher risk mentioned above if a credit check on the assuming party is now allowed. For these reasons, the 12 basis points differential in the example above is only a minimum differential required in the contract rate of assumable as compared to nonassumable mortgages in order to interest investors in the former." (OER Report, pp. 5-6).

Therefore, the Board concludes that elimination of the "due on sale" clause will — even in the private sector — impair the salability of California loans, or cause them

to be sold at reduced prices. In either event, or a combination of both, the Board finds that the financial stability of Federal associations in California will be eroded and the flow of home loan funds into California will be reduced.

III

THE PLAINTIFF'S ECONOMIC ARGUMENTS IN OPPOSITION TO THE "DUE ON SALE" CLAUSE

Because the Board heretofore has sanctioned the use of "due on sale" clauses by Federal savings and loan associations, the Board and its staff have given very careful consideration to the plaintiff's economic arguments in opposition to the exercise of such clause. However, the Board finds such arguments to be unconvincing.

First, the plaintiff argues the the "due on sale" clause has "depressed" real estate values in California (Opening Zamos Affidavit, p. 5). The Board finds this contention to be at variance with the facts. The "due on sale" clause has been in widespread use in California for many years but, as noted by the California Association of Realtors, the value of residential property in California has been increasing at the rate of almost 10% per year (California Realtors Statement, p. 2). Professor Pratt makes the point that the typical house in the Western United States sold for $26,100 in 1967, and that the same house sold for $37,200 in 1973. (Pratt Report, Table 6). This is an increase of 42.5% for the period (the typical house in the United States as a whole sold for $24,600 in 1967, and the same house sold for $35,600 in 1973, an increase of approximately 45%). Therefore, it seems clear that the "due on sale" clause has not slowed down the constant inflationary increase in the price of residential property.

The plaintiff also argues that the exercise of the "due on sale" clause is basically unfair because it ordinarily is cou-

pled with a "prepayment penalty". The Board is not aware, however, that Federal associations in California follow a practice of exercising the "due on sale" clause, and also charging a prepayment penalty because of the acceleration of the maturity of the loan resulting from the effectuation of the "due on sale" clause. Indeed, in the present case, Mission Federal, in its January 20, 1975, letter to the Eimers (which formally notified them that the association had elected to exercise its option to accelerate the maturity of the loan because of the Eimers' sale to Eric Schott), merely requested that the Eimers pay off the principal amount of the loan plus accrued interest; *no demand was made for a "prepayment penalty"*.[17]

The plaintiff repeatedly alleges that the exercise of the "due on sale" clause by Mission Federal constitutes an unreasonable restraint on alienation. However, aside from speculation by counsel, plaintiff has not submitted any evidence or information to the Board which would indicate that the use of the "due on sale" clause by Mission Federal in any way has impaired the ability of its borrowers to sell the real property securing their loans with the association. In this connection, the Board's General Counsel, in his April 28, 1975, letter to counsel for the parties, specifically requested counsel for the plaintiff "to submit any available information as to whether Eric Schott could have arranged other financing — aside from assuming the Eimer loan — to purchase the property in question." Counsel has not submitted such requested information. Instead, Eric Schott merely claims in his Affidavit (pp. 5-6) that in order to refinance the Eimer loan he would have had to pay a "prepayment penalty" to Mission Federal in the amount of

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[17]A copy of Mission Federal's January 20, 1975, letter to the Eimers is attached as Exhibit F to the Affidavit of Eric Schott.

$391.10, plus loan fees to a new lender in the amount of $292.97. There simply is no basis for Eric Schott to allege that he would have had to pay a "prepayment penalty" to Mission Federal, and he could have reduced the other claimed loan fees by assuming the Eimer loan at an increased interest rate which was ¼ of 1% under the existing market rate. The essential situation appears to be that Mr. Schott wanted a 7½% loan when the prevailing market rate was 10½% for the type of loan at issue herein.

Moreover, Mission Federal, like other Federal associations, does not *automatically* exercise its "due on sale" clause in every situation. The association states that it does not exercise such clause under the following circumstances (Defendant's Response, p. 4):

> "(1) When a holder of a junior encumbrance takes the property by foreclosure of his lien.
>
> (2) Upon the death of the obligor when the property is taken by his heirs.
>
> (3) Upon a divorce when the property is subsequently taken over by one of the persons who previously lived there.
>
> (4) When the property is conveyed into a family trust for the benefit of the obligor and/or his family.
>
> (5) When the obligor transfers the property to a blood relative who then occupies property.
>
> (6) Where the situation falls under the general category of 'hardship'."

Moreover, the Board finds that Mission Federal's practice of allowing credit-worthy purchasers to assume its existing loans (at or slightly below the market rate which exists at

the date of the assumption) facilitates — rather than restrains — alienation.[18]

Finally, the plaintiff's central theme appears to be that elimination of the "due on sale" clause will be a pro-consumer action. The Board disagrees. As the plaintiff's own submissions show, elimination of the "due on sale" clause is likely to benefit only some home sellers, since the inflationary increase in the price of housing has reached the point where many buyers lack the financial resources to assume older loans, except through substantial and highly expensive secondary financing. See California Realtors Statement, pp. 2-3.

The Board concedes, however, that invalidation of the "due on sale" clause will enable a certain class of sellers to make a fortuitous profit on the sale of homes with relatively recent low-interest loans (and to sell them more rapidly than other sellers in a tight money market). But it

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[18]The plaintiff has argued that Mission Federal's assumption policy violates a Board regulation, 12 CFR 541.14(a) (1975), which provides that no Federal association shall increase the amount of the periodic installment payments on its loans, which are set to retire the debt, interest and principal on the loan within the loan term (Opening Zamos Affidavit, p. 10). However, this Board has taken the position that in any case where the association releases the original borrower upon the assumption of the loan by the new purchaser, the transaction, in effect, is treated as a new loan to the assuming purchaser, and 12 CFR 541.14(a) is inapplicable to such transaction. Therefore, 12 CFR 541.14(a) would not appear to apply to Mission Federal's assumption program in light of the following statement in Defendant's Response (p. 39):

> ". . . Mission Federal has never at any time during the tenure of the present officers taken any action against an original borrower after there has been an assumption of the loan, nor have they ever heard of any such action having been taken prior to their tenure. The understanding has been that the original residential borrower is no longer responsible for the obligation once the assuming purchaser has legally assumed responsibility for the loan. Consequently, it is Mission Federal's position that the original borrower has been released at such time as an assumption agreement becomes legally effective."

is the Board's firm conviction that such profits will be achieved only at the expense of the general home-buying public, because interest rates on new loans are most likely to be raised to offset the very substantial loss of savings and loan income flowing directly from elimination of the "due on sale" clause, and elimination of the "due on sale" clause will decrease the supply of housing funds which otherwise would be available. Therefore, viewing consumer interests from the broader perspective, it is the Board's opinion that elimination of the "due on sale" clause, at best, will have only a marginal overall consumer benefit, but undoubtedly will cause widespread hardship to the general home-buying public.[19]

IV

CONCLUSIONS OF THE BOARD

Based upon the foregoing, this Board, as the Governmental regulator of Federal savings and loan associations, concludes as follows:

(1). Federal law exclusively governs the validity of "due on sale" clauses in the loan instruments of Federal savings and loan associations.

(2). "Due on sale" clauses are fully permissible under 12 CFR 545.6-11 (1975), the Board regulation governing the terms of the loan documents used by Federal associations.

(3). There are valid and compelling economic and marketing considerations underlying the use and exercise of "due on sale" clauses.

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[19]The Board, of course, recognizes that there may be occasions where an association should use restraint on the exercise of its option to accelerate the maturity of the loan. The limitations on the exercise of the "due on sale" clause followed by Mission Federal (Defendant's Response, p. 4) seem entirely reasonable and prudent. But the situation respecting the assumption by Eric Schott of the Eimer loan clearly does not come within such limitations.

(4). The "due on sale" clause is vital and necessary to enable savings and loan associations to adjust their loan portfolios towards current market rates, thereby protecting the associations' financial stability, and enabling them to make new home loans at lower interest rates than otherwise would be necessary to maintain an adequate yield on their mortgage portfolios.

(5). The "due on sale" clause enables savings and loan associations to sell their existing home loans in the secondary mortgage market in an orderly manner, thereby generating new funds for additional residential loans, which otherwise would be unavailable.

(6). Elimination of the "due on sale" clause is likely to cause higher interest rates on home loans generally, and a reduction of home loan funds.

(7). Elimination of the "due on sale" clause will benefit only a limited number of home sellers, but will cause economic hardship to the majority of home buyers and potential home buyers.

(8). Elimination of the "due on sale" clause will have a much more adverse affect on Federal associations than on State associations in California, and could alter competitive equality between Federal and State associations in that State.

(9). The exercise of the "due on sale" clause on the facts of this case, or generally, does not constitute an unreasonable restraint on alienation.

(10). Mission Federal's requirement that Eric Schott could assume the Eimer loan only at an increased interest rate in line with the current market rate was justified and proper.

By Direction of the Federal Home Loan Bank Board

J. S. Finn
Secretary

EXHIBIT NO. 1

Opinion of the Office of Economic Research On the Revocation of the "Due on Sale Clause" in the State of California

The Office of Economic Research views the revocation of the "due on sale clause" as a factor that will lead to higher mortgage interest rates and will reduce the marketability of such mortgages in the secondary market. These two major points are made below, along with a number of minor points. This opinion was formed after reading the report by Richard T. Pratt Associates and the plaintiffs' reply thereto. Our conclusion is that the due on sale clause is an important part of the mortgage contract throughout the country, and its revocation sets a dangerous precedent in terms of the consequences in the mortgage market.

The Competitive Environment

It is important to place the competitive environment in perspective. A consideration here is the possible impact of variable rate mortgages (VRMs). If mortgage interest rates rise—even just temporarily—mortgages without due on sale clauses are at a disadvantage to those whose rate can rise (the VRMs). Since at least temporary rate increases are likely, lenders who can offer both types of mortgages will tend to offer more VRMs than fixed-rate mortgages, which implies that the effective interest rate on the fixed-rate mortgages will increase and the initial contract rate on the VRMs will fall. As a consequence, fewer fixed-rate and more VR mortgages are likely to result.

Federal S&Ls that cannot offer VRMs will obviously be at a competitive disadvantage. Their volume of mortgage loans will decrease, and over time when rates increase, their income will suffer. The major consequence, then, if VRMs

become the primary type of mortgage instrument, is that Federal S&Ls will be forced out of existence.

However, as the plaintiffs showed, California VRMs are limited in their ability to keep up with large increases in mortgage rates and in the cost of funds. Thus, the competition to the assumable fixed-rate mortgage by the (assumable) VRM may not be significant, and potential borrowers may still opt for the fixed-rate mortgage at a higher rate than that on the VRM. The rest of this paper assumes that the VRM will not become a significant factor in the competitive environment for the assumable fixed-rate mortgage.

Increase in the Mortgage Rate

Without the due on sale clause, there are likely to be more assumptions of existing mortgages. It is likely, as pointed out by Pratt, that "wraparound" financing will become prevalent,[1] implying that even on houses whose market value has increased substantially, existing mortgages are likely to be assumed if their rate is below the current mortgage rate.[2]

Thus, the likely impact of universal (or statewide) assumable mortgages is a lengthening of the life expectancy, or prepayment period, of mortgages. If mortgage rates remain constant or only go downward and never rise, mortgage borrowers and lenders would be virtually unaffected. When rates fall, many borrowers would refinance regardless of the assumability of the loan, although assumability increases the potential net gain to the borrower from refi-

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[1]Contrary to Pratt's assertion, in a competitive environment the rate of return to issuers of the wraparounds (as opposed to the coupon rate on the wraparound loan) will be driven down to the market yield on fixed-rate mortgages.

[2]Again, this conclusion is contrary to Pratt's assertion.

nancing, since it extends the benefit of a lower mortgage rate to beyond the point in time when the house may be sold, and the borrower can reap this benefit (if rates increase) in terms of a higher house price or a shorter time required to sell it.

However, it is likely that at least a few times in the future, mortgage rates will increase. At such times, S&Ls' cost of funds will be typically rising as well (sometimes faster than current mortgage rates). Table 1 shows that when mortgage rates increase, the average portfolio yield increases only slowly, and that it increases even less rapidly the longer the term to prepayment. The consequence is that when interest rates are rising, S&Ls' cost of funds are increasing much faster than are portfolio yields, causing reduced or even negative earnings. If interest rates remain high or keep rising, the consequences could be severe, such as insolvency. If the rise is only temporary, mortgage flows are curtailed, and mortgage rates rise as a consequence.

Table 1. Cumulative Increase in the Average Portfolio Yield for Various Increases in the Current Mortgage Rate an .... Various Terms to Prepayment (Percentage Points)

	Years to Prepayment of the Mortgage			
	30	20	10	5
	AFTER ONE YEAR			
Maintained Increase in the Current Mortgage Rate over the Initial Average Portfolio Yield (Percentage Points)	(%)	(%)	(%)	(%)
0.5	0.06	0.07	0.09	0.14
1.0	0.12	0,14	0.18	0.27
1.5	0.18	0.20	0.27	0.41
2.0	0.24	0.27	0.36	0.55
2.5	0.30	0.34	0.45	0.68
	AFTER TWO YEARS			
0.5	0.11	0.13	0.17	0.24
1.0	0.23	0.25	0.33	0.47
1.5	0.34	0.38	0.50	0.71
2.0	0.46	0.51	0.66	0.94
2.5	0.57	0.64	0.83	1.18

AFTER FIVE YEARS				
0.5	0.24	0.26	0.32	0.50
1.0	0.48	0.52	0.63	1.00
1.5	0.71	0.78	0.95	1.50
2.0	0.95	1.04	1.27	2.00
2.5	1.19	1.30	1.58	2.50

Note: It was assumed that the mortgage stock increases at 10 percent per year, and that all mortgages are repaid in the prepayment period specified in the column headings.

However, these consequences will be perceived, or expected, by the participants in the mortgage market. By expecting a lower yield from an assumable mortgage as compared to a non-assumable one, lenders will require a higher initial interest rate. (The effective yield will increase, which includes points and fees as well as the contract interest rate.) Borrowers may be willing to pay a higher rate because of the potential capital gain they may realize when they sell their house. Also, the contractual maturity will tend to decrease as lenders attempt to offset the expected lengthened actual maturity (to prepayment), but the amount it can reasonably decrease is limited by the burden it imposes on the payment ability of borrowers. Also, prepayment fees and refinancing fees can be expected to decrease, implying still more upward pressure on the current mortgage rate.

If lenders do not have the ability to screen the party assuming the loan, then the riskiness of the loan increases. As a matter of standard practice, the credit worthiness of borrowers is an important element determining the issuance of a mortgage, since slow and delinquent loans are costly and may even cause concern by regulators. If no credit

check on the assuming party is possible, the risk becomes greater on the initial loan. As a consequence, the current mortgage rate must rise to offset this increased risk element.

To summarize the major point, in a market like the current one where mortgage rates are expected to rise either secularly or cyclicly—or both—the current mortgage rate must rise to compensate lenders for an expected lower yield because of the lack of the due on sale clause.

Reduced Marketability in the Secondary Market

Given a choice between a mortgage with a due on sale clause and on one without it, both at the same contract rate and purchase price, a purchaser in the secondary market would select the one with the due on sale clause. Stated another way, the contract rate must be higher on the mortgage without the clause than on the one with it in order to interest the purchaser. Since mortgage rates will tend to increase in California, they may increase enough to maintain their marketability, but this is an unanswerable question at this point.

As mentioned above, one of the effects of the lack of a due on sale clause is to reduce the expected maturity of mortgages. This fact, in and of itself, implies a lower return on mortgages selling below par. For example, an 8-percent, 25-year mortgage that is selling at 98 would yield 8.36 percent if it were anticipated that its effective maturity is 8 years, but its yield is reduced by 12 basis points to 8.24 if its effective maturity were anticipated to increase to 20 years because the due on sale clause is excluded. Looked at another way, to keep the yield at 8.36, the price would drop from 98 to 97.

However, this yield differential does not account for the income foregone by not turning over the investor's money into a higher yielding instrument in the eighth year as op-

posed to waiting until the twentieth year. Also, the market expectations embodied in the price of 98 must incorporate a level as opposed to a fluctuating mortgage rate forecast. It also does not account for the potentially higher risk mentioned above if a credit check on the assuming party is not allowed. For these reasons, the 12 basis points differential in the example above is only a minimum differential required in the contract rate of assumable as compared to nonassumable mortgages in order to interest investors in the former.

Additional Points and Comments

When mortgage rates increase, the (usually unrealized but nevertheless very real) capital loss of the lender when the purchaser of a house also assumes the existing mortgage (either by a wraparound deal or whatever) becomes the capital gain of the seller. Either the house price is increased appropriately or the sale is more timely, or both; and in either case the seller gains at the expense of the lender. Since in aggregate the original borrowers must pay for the privilege of an assumable mortgage in the form of a higher initial mortgage rate, those that actually gain are those fortuitous enough to sell their houses when mortgage rates are high. Those who lose are borrowers whose contract rate happens to be above the current mortgage rate when they sell—they have paid for a privilege but were not able to capitalize on it.

Another point is that if wraparound deals are not easy to obtain, higher downpayments are likely to be required, as Pratt points out, or costly second mortgages may be necessary if the primary market is suffering from mortgage stringency.

As a matter of practice, since the credit worthiness of the borrower is examined as well as the value of the property, the mortgage appears to be applied to the borrower as well

as to the property. It appears erroneous in terms of standard practice to assume that the loan applies strictly to one or the other, as the plaintiffs attempt to argue.

It would appear to be a logical extension of the revocation of the due on sale clause for mortgages to apply the principle to all durable assets, such as for loans on automobiles, mobile homes, appliances, etc. Imagine the consequences if the precedent being set for the mortgage market were to be applied to these other loans; e.g., the credit worthiness of someone buying a used car would become irrelevant.

/s/ Harris C. Friedman

Harris C. Friedman
July 9, 1975
Director, Office of Economic Research

Monograph No. 14

An Economic Analysis of
The "Due on Sale" Clause in
The California Mortgage Market
1979

[logo] Credit Research Center
Krannert Graduate School of Management
Purdue University

THE CREDIT RESEARCH CENTER, established in 1974, is a publicly supported, nonpartisan research and educational organization. Its purpose is to stimulate and support unbiased research in the field of consumer and mortgage credit and to further the educational purposes of the Krannert Graduate School of Management of Purdue University. The center's research focuses upon issues relevant to the credit industry, consumers, and governmental bodies. The center operates as a nonprofit organization within Purdue University. The publications of the Credit Research Center take three major forms:

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AN ECONOMIC ANALYSIS OF THE "DUE ON SALE" CLAUSE IN THE CALIFORNIA MORTGAGE MARKET

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INTRODUCTION AND SUMMARY

Two recent decisions of the California Supreme Court have drastically changed the standard mortgage contract used in the State of California. In the case of *Tucker v. Lassen Savings and Loan Association* in 1974 the court decided that automatic enforcement of a "due on sale" clause when property is sold on instalment contract constitutes an unreasonable restraint against alienation, *i.e.*, it inhibits the saleability of the property. On August 25, 1978, in the case of *Wellenkamp v. Bank of America et al.*, the Court extended its earlier decision and held that automatic exercise of the "due on sale" clause in an outright sale of property is also an unreasonable restraint on alienation. These decisions have immediate and significant implications for the availability and pricing of mortgage loans in the State of California and, to the extent that the California decisions are harbingers of actions in other states, around the country.

California stands alone in its negative view of the "due on sale" clause. Virtually every other state has either explicitly or implicitly recognized the useful role served by the "due on sale" clause in fixed-rate mortgage loans in times of high and volatile interest rates. While the "due on sale" clause once primarily served as a control on the credit worthiness of new home owners assuming mortgages, it is now used to limit the expected maturity of fixed-rated mortgage loans. This limits the amount of insurance against interest rate fluctuations which is sold to the borrower in a fixed-rate mortgage. California's restriction on the use of the "due on sale" clause is in vivid contrast to its progressive attitude on the use of alternatives to the fixed-rate mortgage, particularly the variable-rate mortgage. By permitting innovative new mortgage loans on the one hand but at the same time restricting important terms of the standard

mortgage contract, the state courts and regulators have created one of the most unusual mortgage markets in the country. The question at issue concerning this market is whether the right to form fixed-rate mortgage contracts with the "due on sale" clause, like the right to contract for VRM's, is in the consumers' best interests.

This report examines the economics of the "due on sale" clause in a mortgage loan, with particular emphasis on the role of the "due on sale" clause in the California mortgage market. Although economists have written extensively on the mortgage market in California and throughout the nation, very little attention has been directed explicitly toward the "due on sale" clause. While this inattention is explicable, it is unfortunate because the Court in evaluating the "due on sale" clause has had no well received economic analysis upon which it could rely. As a result, in restricting the use of the "due on sale" clause it has unwittingly deprived consumers of the right to use a valuable form of mortgage contract. This report contains an economic analysis of the "due on sale" clause which demonstrates why unrestricted use of the clause is in the interest of both borrowers and lenders. In addition, the report indicates a need for potential legislative action restricting the imposition of fixed charges in conjunction with exercise of the "due on sale" clause.

The report is divided into four chapters, the first of which provides an overview of the California mortgage market. It documents the types and sizes of institutions in the market and characterizes the economics of mortgage lending in a time of high and volatile interest rates. It is pointed out that the primary source of funds for mortgage borrowers is savings and loan institutions which are compelled to obtain funds with short maturities but make loans with long maturities. The basic problem for an efficient mortgage market is explained as one of intermediating across time.

Chapter II is devoted to analysis of the pricing of fixed-rate mortgage contracts with and without the "due on sale" clause. It is demonstrated that, other things being constant, a fixed-rate mortgage without the "due on sale" clause will have a higher price because it insulates the borrower against fluctuations in interest rate to a greater degree than does a mortgage which includes the clause.

Chapter III summarizes the history of the "due on sale" clause in the California courts. In addition, the economic basis of the arguments used by the Supreme Court in the Wellenkamp decision is critically evaluated. It is argued that the Court's decision reflects a lack of understanding of the pricing of fixed-rate mortgages. Specifically the Court's decision does not appreciate the fact that the right to a specific interest rate is a product which is sold in the market place. The "due on sale" clause defines the characteristics of the product and, therefore, the price that it will command.

The fourth chapter of the report examines the economic impact of restricting use of the "due on sale" clause. First, it is argued that because there are existing mortgages which were priced on the assumption that the "due on sale" clause could be exercised, *ex post* restrictions on the exercise of the clause create a boon for *current* property owners but penalize lenders. It should be noted that new buyers of property receive no benefit. Second, it is argued that mortgage rates will increase for fixed-rate loans deprived of the "due on sale" clause. Third, it is argued that this hurts the vast majority of consumers who probably would have otherwise preferred a fixed-rate loan with a lower rate and the "due on sale" clause because they are now forced to choose between the variable-rate mortgage and the fixed-rate loan without the clause. Finally, it is argued that such restrictions could only be justified if lenders could use the "due on sale" clause to take unfair advantage of consumers.

The only serious opportunity for such a practice lies in the ability to extract prepayment penalties in conjunction with exercise of the "due on sale" clause.

CHAPTER I
CALIFORNIA SAVINGS AND LOAN ASSOCIATIONS AND THE PROVISION OF MORTGAGE CREDIT

The savings and loan industry is both the nation's and California's largest supplier of residential home mortgages, and it is the only major financial intermediary which is constrained by law and regulation to employ its assets in residential mortgage lending. Because of its inability to shift into or out of residential mortgages, this industry is the most heavily affected by the "due on sale" clause decisions. This chapter explores the nature of savings and loan associations and their financial profile in the State of California. It also provides a review of the financial services involved in residential mortgage markets. The financial functions performed by mortgage lending associations will be examined and an analysis made of the mortgage instrument in terms of the economic questions raised by the recent California Supreme Court decisions concerning the "due on sale" clauses.

California Savings and Loan Associations

In California, as in the balance of the nation, the single largest provider of mortgage loans for owner-occupied dwellings is the savings and loan business. Because of its dynamic nature in terms of economics and demographics, the State of California has traditionally led the nation in mortgage lending activity. In 1976, of approximately $77 billion of mortgage loans made by insured savings and loan associations in the United States, more than 23 percent were handled by California firms

Table I gives an indication of the assets in mortgage portfolios of California's savings and loan institutions as of December 31 of each year since 1973. As the table shows, the 1977 total assets of the associations domiciled in California were $83.3 billion, $55 billion of which were of those institutions licensed by the State of California. The involvement of savings and loan associations in the mortgage market is indicated by the $70.7 billion of assets held in mortgages. Approximately 85 percent of all associations' total assets were committed to mortgage loans, while for state-chartered associations the ratio was 86 percent or greater over the five-year period shown. When allowances are made for required working capital funds and legally required liquidity, the only major asset of California savings and loan institutions is their mortgage portfolio. The apparent demand for financial services provided by savings and loan institutions has been strong in California during the past five years. From 1973 to 1977, asset growth of these institutions averaged 15 percent per year, while the associated mortgage portfolios grew at an average rate of 14.5 percent. At a compound annual growth rate of 14.5 percent per year, California savings and loan associations are doubling their mortgage portfolios approximately every five years.

Because of the predominance of mortgage loans in the portfolio, interest from loans and contracts provides the majority of association income. In 1977, approximately 81 percent of gross operating income of associations was provided by interest on mortgage loans and contracts. It is interesting to note that while savings and loan associations held 85 percent of their assets in mortgage loans for 1977, these assets provided only 81 percent of the associations' income. Table II provides a recap of the interest earned on mortgage loans for the period 1973 through 1977. As the

exhibit shows, yields on mortgage portfolios have been increasing in line with generally increasing interest rates in the economy and the roll-over of lower yielding loans into newer, higher yielding loans. The average yield over the five-year period increased from 7.3 percent to 8.2 percent or an increase of 90 basis points.

TABLE I
Assets and Mortgage Portfolios of
Insured California Savings and Loan Associations*

	Total Assets (bil. of dollars)		*Mortgage Loans (bil. of dollars)*		*Mortgage Loans a Percent of Total As*	
	Total	State Chartered	Total	State Chartered	Total	State Chartered
1973	47.1	21.8	41.1	28.0	87	88
1974	50.8	33.8	43.8	29.5	86	87
1975	58.0	37.6	49.1	32.5	85	86
1976	69.1	45.1	58.6	38.8	85	86
1977	83.3	55.0	70.7	47.5	85	86

*Figures are as of December 31.

Source: Federal Home Loan Bank Board, *Combined Financial Statements FSI Insured Savings and Loan Associations 1973 through 1977.*

TABLE II
Return On Mortgage Portfolios of Insured
California Savings and Loan Associations*

	Mortgage Loans (bil. of dollars)	*Interest on Loans (bil. of dollars)*	*Average Yield Percent*
1972	37.2	—	—
1973	41.1	2.87	7.3
1974	43.8	3.19	7.5
1975	49.1	3.56	7.7
1976	58.6	4.27	7.9
1977	70.7	5.32	8.2

*Yields are computed by dividing beginning and ending mortgage loan balances two times interest on loans.

Source: Federal Home Loan Bank Board, *Combined Financial Statements FSI Insured Savings and Loan Associations 1972 through 1977.*

The greatest proportion of savings and loan association assets is invested in mortgage loans, and the largest single source of funds is savings accounts solicited from the general

public. Of the approximately $73.8 billion dollars of liabilities held by California associations at the end of 1977, $66.9 billion were provided by savings accounts. Savings accounts supply about 80 percent of the funds to finance association assets. The majority of the capital costs of associations are incurred in purchasing savings balances. Table III shows the average cost of savings to California associations over the period 1973 to 1977. This cost had been rising on a basis similiar to that of the yield on mortgage loans, and has grown from 5.6 percent in 1973 to an average cost of 6.5 percent in 1977. It is the spread between the cost of funds — which, to a large extent, is the cost of savings — and the yields achieveable on the mortgage portfolio which determines the ability of the savings and loan industry to satisfy the continued demand for mortgage funds.

The cost to associations of providing mortgage credit and savings services is reflected in the schedule of operation costs for California's savings and loan industry. Table IV shows operating costs for California associations for the period 1973 through 1977. As shown, there is some upward trend in the operating costs of these institutions, with 1977 levels amounting to 1.33 percent of mortgage loans and 1.13 percent of assets. Average operating costs for the five-year period was 1.29 percent of loans and 1.11 percent of assets. Associations perform their intermediating function of obtaining savings and making mortgage loans at a cost of approximately $1 per year for each $100 of funds handled.

TABLE III
Cost of Savings of Insured
California Savings and Loan Associations[a]

	Savings Accounts (bil. of dollars)	*Cost of Savings (bil. of dollars)*	*Average Cost Percent*
1972	35.7	—	—
1973	37.8	2.07	5.6
1974	39.4	2.33	6.0
1975	47.1	2.72	6.3
1976	57.1	3.31	6.4
1977	66.9	4.01	6.5

[a]Average costs are computed by dividing two times the cost of savings by beginning and ending savings accounts.

Source: Federal Home Loan Bank Board, *Combined Financial Statments FSLIC-Insured Savings and Loan Associations 1972 through 1977.*

TABLE IV
Operating Expenses Insured
California Savings and Loan Associations

	Assets (bil. of dollars)	*Mortgage Loans (bil. of dollars)*	*Operating Costs (bil. of dollars)*	*Cost as Percent Of Loans*	*Cost as Percent Of Assets*
1973	47.1	41.1	.49	1.19	1.04
1974	50.8	43.8	.56	1.28	1.10
1975	58.0	49.6	.65	1.31	1.12
1976	69.1	58.6	.79	1.35	1.14
1977	83.3	70.7	.94	1.33	1.13
				1.29%	1.11%

Source: Federal Home Loan Bank Board, Combined Financial Statements FSLIC-Insured Savings and Loan Associations 1973 through 1977.

TABLE V
Profitability of Insured California
Savings and Loan Associations

	Net Income (bil. of dollars)	*Assets (bil. of dollars)*	*Net Worth (bil. of dollars)*	*Net Income / Assets (percent)*	*Net Income / Net Worth (percent)*
1973	.38	47.1	3.28	.81	11.59
1974	.29	50.8	3.49	.57	8.31
1975	.33	58.0	3.72	.57	8.87
1976	.55	69.1	4.22	.80	13.03
1977	.82	83.3	4.76	.98	16.53
				.75	11.67

Source: Federal Home Loan Bank Board, *Combined Financial Statement FSLIC-Insured Savings and Loan Associations 1973 through 1977.*

A final picture of the financial positions of the California savings and loan associations can be drawn from examination of the profitability of associations over the past five years. Table V provides a record of net income as it relates to assets and net worth over the past five-year period. It shows a decline in profitability during the early part of the period, with a strong resurgence in 1976 and 1977. Over the five-year period, associations achieved a profitability level of .75 percent as a return on year-end assets and 11.67 percent on net worth.

The preceding illustrations concerning mortgages, savings, operating costs and profitability provide some background for discussing the economics of the "due on sale" clause and its effect on California's mortgage markets. The following section further investigates the nature of mortgage lending in California and, more specifically, the role of savings and loan associations.

Savings and Loan Structure in the State of California

Historically, there have been three major types of savings and loan associations operating in the United States, each subject to somewhat different regulatory constraints. These

three types have been first, the mutual savings and loan association chartered by the federal government and having no capital stock holders. Ownership of this type of association is vested in the savings account holders and in some states also the association's borrowers. While questions of federal preemption have been raised in the State of California, generally speaking federal mutual associations are supervised and regulated by the federal government. The principal regulators are the Feder Savings and Loan Insurance Corporation and the Federal Home Loan Bank Board. The second major type of savings and loan association is the state-chartered mutual association, which is similar in its organization to the federally-chartered mutual, but which has as its chartering authority the state in which it is domiciled. These associations are subject to the jurisdiction of the state savings and loan, or financial, commissioner, and in the case of insured associations, to the Federal Savings and Loan Insurance Corporation. The third type is the state stock association, which is chartered by the individual states and the organization of which is similar to that of commercial banks or other ordinary corporate concerns having common stock holders as the final and residual owners. In a net financial sense, one of the major differences between the mutual and stock forms of organization is that a common stock dividend is never paid by mutual institutions. The stock form of organization is, or course, entitled to pay a dividend if earnings are available, and it commonly does so. In the State of California, as of December 31, 1977, there were 165 federally-insured savings and loan associations. Seventy-four of these were federally-chartered, eight were state mutual associations, and 83 were state stock associations. Recently, while the federal gov-

ernment has not chartered new stock associations, it has allowed mutual (federal and state) associations to convert to a capital stock type of association on a limited basis.

Financial Services of Savings and Loan Associations

In accepting savings deposits and making mortgage loans, savings and loan associations and other mortgage lending thrift institutions are actually performing a number of financial services. Savings and loan associations belong to a group of institutions known as financial intermediaries. A financial intermediary is a financial institution or an individual taking a position between the original sources of investment capital and its final use for real investment. George G. Kaufman in his work "Financial Intermediaries and Variable Rate Mortgages,"[1] describes four types of intermediation performed by mortgage lending institutions. These are (1) denomination intermediation, (2) maturity intermediation, (3) risk intermediation, and (4) interest rate intermediation.

Denomination Intermediation

In performing denomination intermediation, mortgage lending institutions assemble funds through savings accounts and other debt obligations of various denominations and make mortgage loans of various denominations. In the absence of a financial intermediary, an investor would be required to invest the amount of mortgage funds which a borrower wished to borrow, or a borrower would have to be willing to borrow the amount which an investor had available to lend. Because of denomination intermediation, savings accounts are available in any denomination from

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[1]Federal Home Loan Bank Board, "Financial Intermediaries and Variable Rate Mortgages," ed. George G. Kaufman, Invited Research Working Paper No. 16, August 1977, p. 7.

$1 to millions of dollars. Certain accounts require denominations of at least a minimum fixed amount, but in general a complete array of denominations is available to the saver. A borrower is able to borrow the amount of funds which he requires for a project without concern for the amount savers wish to save. The intermediary steps between the saver and the borrower and assembles or disassembles savings accounts and assembles or disassembles borrowers so as to profitably employ all savings funds available and clear the mortgage markets.

Maturity Intermediation

Mortgage lenders—and savings and loan associations in particular—are perhaps best known for their maturity intermediation. In plain language, the maturity intermediation performed by savings and loan associations is accomplished by borrowing short and lending long. The liabilities of a savings and loan association vary from virtually demand liabilities to those having maturities of five to ten years with some exceptions, such as mortgage pass through securities, which have longer maturities. As of September 1977, insured savings and loans in the U.S. had 40 percent of their consumer savings accounts in demand type passbook accounts, though this has declined more recently, and over 77 percent of savings accounts had maturities of less than two years. All savings and loan associations obtain their funds through short-term sources, while their predominant use of funds is for long-term permanent mortgage loans having maturities in the range of 25 to 30 years. The demand for maturity intermediation is evidenced by the massive use of maturity intermediating institutions by both savers and borrowers. Maturity intermination allows those having excess funds to place them on deposit based on the saver's preferred maturity. Through the use of passbook accounts,

the saver is able to earn an interest return on deposits of an uncertain maturity. For those having more highly specified expectations concerning their future need for funds and liquidity, specific maturities are offered. At the same time, savings and loan associations through maturity intermediation are providing long-term, fixed-rate loans which remove from the borrower all interest rate risk and funds availability risk.

Risk Intermediation

Financial institutions reduce risk and improve the efficiency of money and capital markets. When financial intermediaries are federally insured institutions, risk intermediation is combined with insurance to further differentiate the risk of institution assets and liabilities. In offering mortgage credit, savings and loan associations provide loans on residential, commercial and other types of property. The risks associated with these loans include risk characteristics associated with the borrowers, the extent of exposure which the institution has on the loan, and the demand factors which determine the intrinsic value of the property which is used as security. The risk associated with an individual piece of property may be substantial and may exceed the risk which the saver would be willing to bear in a direct investment. The uncertainty or risk associated with a large portfolio of such mortgage loans is greatly reduced. Because of diversification and portfolio effects, the relative risk of the total portfolio will be substantially below the risk associated with individual loans. As a result of this, the financial institution can issue liabilities which have lower risk than the individual assets of the association. In order to further reduce the risk of liabilities issued by major financial intermediaries, federal agencies including the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Cor-

poration have been created to insure savers against financial loss. Deposits in federally insured savings and loan associations, up to the insurance limit, can be considered essentially as safe as direct investment in U.S. Government securities.

Interest Rate Intermediation

Interest rate intermediation exists when the period for which the interest rate is fixed on an association's liabilities differs from the period during which the interest rate is fixed on the association's assets. When a savings and loan association takes fixed-rate deposits and makes variable-rate mortgage loans it is performing interest rate intermediation. The best example of this is, of course, the issuance of variable-rate mortgage loans by state-chartered savings and loan associations in the State of California.

Competition For Mortgage Loans

While all savings and loan associations in the State of California have relatively similar powers in regard to the deposit liabilities which they may create, the recent decisions concerning the "due on sale" clause have substantially altered both the nature of the existing mortgage loans of state-chartered associations and their ability to offer a full range of mortgage loans in the future. The three types of permanent residential mortgage loans which are offered by California savings and loan associations include (1) the fixed-rate, fixed-term loan, (2) the fixed-rate, fixed-term loan including an enforceable "due on sale" clause, and (3) the variable-rate mortgage loan. The fixed-rate, fixed-term loan is made at a given interest rate for a given number of years and does not include the "due on sale" clause, or it includes a "due on sale" clause which has been rendered unenforceable by the California Supreme Court at state chartered savings and loans.

The fixed-rate, fixed-term loan with an enforceable "due on sale" clause is a loan for a specified maturity and a specified interest rate, as in the previous case. However, the loan may be called or its interest rate may be adjusted in the event that ownership of the property changes. The variable-rate mortgage, which has been pioneered on a large scale by California institutions, incorporates a mortgage interest rate which may change from time to time based on an interest rate index.

State-chartered associations are allowed to make fixed-rate, fixed-term loans, but are not allowed to make fixed-rate, fixed-term loans which include a "due on sale" clause for the purpose of adjusting interest rates, and are not allowed to enforce such a clause in existing loans. State-chartered associations are allowed to make variable-interest rate mortgage loans. Federally chartered associations are allowed to make fixed-rate, fixed-term loans, and are allowed to include a "due on sale" clause for purposes of interest rate adjustment. Since January 1, 1979 federally chartered savings and loan associations with home offices in California have been authorized to provide variable interest rate mortgage loans.

The "Due on Sale" Clause in the Provision of Financial Service

The California Supreme Court, by its recent decision concerning the "due on sale" clause, has caused two important impacts on institutional mortgage lenders and their saving and borrowing customers. First, the Court action has tended to hurt those who will be borrowing from state-chartered savings and loan associations in the future and from the equity security holders of those associations, and to benefit those individuals who currently have mortgage loans in place. Second, the Court has removed the right of

state-chartered savings and loan associations to offer a full range of maturity intermediation.

The following chapters will examine the implications of these actions and their impact on existing and prospective savers and borrowers in California.

CHAPTER II
THE ROLE OF THE "DUE ON SALE" CLAUSE IN MORTGAGE LENDING

Introduction

The "due on sale" clause has served two basic functions in mortgage lending. Prior to the advent of high inflation rates and accompanying high, volatile interest rates in the 1960's, the "due on sale" clause was used primarily to insure the mortgages were not transferred to borrowers with high probabilities of default. That is, when a property was sold the mortgage was called due only if the new owner was viewed as uncreditworthy. However, as the economic environment in California and the nation changed from one of relatively stable prices and interest rates to one of high inflation and volatile interest rates, the principal role of the "due on sale" clause was transformed. It has become an important tool used by savings and loan institutions to control the expected maturity of their fixed-rate mortgage loans.

The principal objective of this chapter is to demonstrate the economic consequences for the pricing of fixed-rate mortgage loans which would follow from depriving mortgage borrowers and lenders of use of the "due on sale" clause. It will be demonstrated that without the "due on sale" clause mortgage lenders will have longer expected maturities on their loan portfolios than with the "due on sale" clause. As a result, lenders who promise a fixed interest rate for the life of the mortgages they issue will be committed to that fixed rate for a longer time period than

if they issued mortgages with the "due on sale" clause. In effect, they will be issuing greater insurance against interest rate risk than was provided when they originated a mortgage incorporating a "due on sale" clause, in that, on average, borrowers will be insulated from fluctuations in market interest rates for a longer period of time. The increased insurance has a cost to the lender which, without other offsetting provisions in the loan contract, will have to be recovered from the borrower in the form of higher contract rates on fixed-rate mortgages. In this chapter no conclusions are drawn as to whether such changes will be in consumers' best interests (that is the subject of Chapter IV). This chapter merely points out the inevitable economic result of lengthening the average maturity of fixed-rate loans by the elimination of the "due on sale" clause.

This chapter is divided into two sections, with the first section presenting a discussion of the pricing of fixed-rate loan contracts when lenders acquire funds in short-term financial markets with fluctuating rates without use of a "due on sale" clause. The second section describes the impact on the pricing of these types of debt instruments when the maturity of the contract is lengthened through restrictions on the use of a "due on sale" clause. This section also points out that elimination of the "due on sale" clause would have the effect of increasing the contract rate on mortgage loans.

Pricing of Fixed-Rate Mortgage Loans

As discussed in Chapter I, the economic fact of life for California savings and loan associations, and, in fact, for all savings and loan institutions in the country, is that they make loans with very long contract maturities but obtain funds with very short maturities. To a large degree this is because savings and loan associations are a unique type of

financial institution created by legislative action specifically to provide mortgage loans financed largely by consumer savings. However, financial institutions in general provide a service which may be described as intermediating across time, i.e., borrowing short and lending long. But they only do so if they expect to make a profit from the provision of this risk-bearing service. Moreover, the larger the risks involved in such intermediation, the larger the price that will be demanded for long-term fixed-rate loans in a competitive market for intermediation.

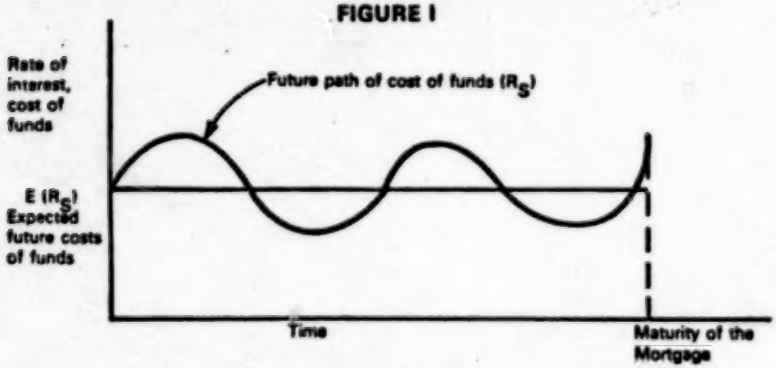
In mortgage markets there are three basic determinants of the price demanded by lenders for intermediating across time by offering fixed-rate mortgage loans. These items are:

1. The risk aversion of lenders in the mortgage market, i.e., the premium that they demand to bear a specific amount of risk.
2. Lenders' expectations of the level and variability of future interest rates which are a proxy for their future cost of funds.
3. The extent to which legal, administrative or contract constraints increase or decrease the effect of variations in interest rates, e.g., rights of prepayment, prepayment penalties, etc.

In order to determine the impact of these factors on loan pricing, it is useful to consider a highly simplified mortgage market where lenders demand no premiums to accept risk, and where it is impossible for borrowers to refinance their mortgages if interest rates fall, i.e., there are infinite penalties for prepayment. Suppose also that lenders' costs of funds fluctuate in future periods and that lenders do not know with certainty what these future costs will be. A hy-

pothetical path for the future cost of funds for a lender is illustrated in Figure 1. The curve in this figure exhibits no

FIGURE I



trend in the average cost of funds through time. Hence, lenders' expectations can be characterized in this simple case as being independent of time, such that lenders expect that the cost of funds will not increase or decrease through time. However, they do not know for sure what the cost will be in any particular future period.

Under these simplifying assumptions, lenders in a competitive mortgage market will expect to break even if they price fixed-rate loans so that the rate demanded — which can be represented as R_L — will be equal to the expected future costs of funds, $E(R_S)$, plus the lenders' other operating costs. The curves in Figure 1 illustrate why lenders will price in this manner. The lender expects that when the cost of funds rise above the expected rate a loss will be incurred, but when the cost of funds falls below the expected rate a profit will be made. As long as the rate on the loan is equal to the expected future cost of funds plus a margin for operating costs, losses will just offset profits and the lender will expect to break even over the life of the mortgage.

TABLE VI
Prepayment Charge*
25 Year Loan
Nine Percent Interest Rate on $10,000 Loan

Year of Prepayment	*Amount Prepaid*	*Prepayment Charge*	*Cost of Loan Over Period Held (percent)*	*Refinancing Rate at Which Borrower Has An Advantage From Prepayment (percent)*
5	$9,327.00	$330.00	9.53	8.66
10	$8,274.00	$282.00	9.19	8.43
15	$6,625.00	$208.00	9.08	8.28
20	$4,043.00	$ 92.00	9.02	8.04

*Assumes maximum prepayment charge allowed by federally chartered savings and loan associations. Prepayment charge of six months interest on the amount prepaid less 20 percent of the original loan balance.

Figures in this table were calculated in the following manner, using as an example the 10-year prepayment.

1. Figure the payment on a 9%, 25-year loan with monthly payments having an original balance of $10,000. The payment equals $83.9196.
2. Figure the payoff at end of year 10. The payoff, or unpaid balance, at year 10 equals $8273.92.
3. Figure prepayment penalty. Prepayment penalty equals $8273.92 minus (.2 × $10,000) × .09 × .5 which equals $282.32. Total for total payoff including the prepayment charge equals 8273.92 + 282.32.
4. The interest rate over period the loan held equals that rate of discount which equates a stream of 120 payments of $83.9196 + a terminal amount at month 20 of $8556.24 to the original amount of the loan, $10,000. Rate equals a 9.1843 percent.
5. Breakeven or refinancing rate at which borrower has an advantage from prepayment is calculated by finding the rate of interest which equates the original payment of 83.9196 over a 15-year period to the amount which would have to be borrowed to pay off the original loan, $8556.24. This rate equals 8.4327 percent. This approach assumes that only the outstanding balance of the original loan is refinanced and no additional borrowing occurs.

NOTE: Under California law, this table would be relevant only to prepayments made within the first five years of the mortgage. The calculations ignore any incentive to wait for the end of the five-year period when prepayment penalties apply.

The actual operation of the California mortgage market is complicated by the fact that the assumptions invoked to

simplify the pricing decisions do not necessarily hold. It is important to see the impact on the lender's pricing decision of dropping these assumptions. First, in the actual marketplace for mortgage loans it is possible to prepay when interest rates fall. If borrowers incurred no prepayment penalty, then whenever mortgage rates fell borrowers would pay off their outstanding loans and refinance at the new lower rates. Hence, lenders would no longer be assured that the losses they incurred when their cost of funds rose would be balanced by profits made when rates declined. Profits would be reduced, or losses incurred, as borrowers refinanced when mortgage rates fell. It is important to recognize that mortgage rates will not perfectly follow fluctuations in the lenders' costs of funds. Mortgage rates will change only when expectations of future short-term interest rates change. When mortgage rates fall below existing contract rates, borrowers determine whether it is profitable to prepay by comparing the magnitude of prepayment penalties plus the cost of a new loan with the cost of maintaining the original mortgage. If prepayment penalties are very high, the expected losses from prepayments will be low and lenders will set prices as described above. If prepayment penalties are low, lenders will be compelled to increase the price they charge for fixed rate loans to cover the expected losses from prepayment when new mortgage rates decline. Examples of the borrower's prepayment decision are presented in the Tables VI and VII. The tables indicate the interest rate decline that would be necessary for prepayment to be profitable depending on the time to maturity of the mortgage and its original terms. It should be noted that California statutes now prohibit any prepayment penalties after a loan has matured for a period of five years.

TABLE VII
Prepayment Charge*
30 Year Loan
10.5 Percent Interest Rate on $10,000 Loan

Year Prepayment	*Amount Prepaid*	*Prepayment Charge*	*Cost of Loan Over Period Held (percent)*	*Refinancing** Rate at Which Borrower Has An Advantage From Prepayment (percent)*
5	$9,687.75	$403.61	11.11	9.97
10	$9,161.84	$376.00	10.72	9.91
15	$8,274.84	$329.43	10.59	9.81
20	$6,778.82	$250.89	10.54	9.64
25	$4,255.63	$118.42	10.51	9.32

*Assumes maximum prepayment charge allowed by federally chartered savings and loan associations. Prepayment charge is six months interest on the amount prepaid less 20 percent of the original loan balance.

**Assumes that each borrower will refinance the unpaid balance and prepayment penalty over a period equal to the remaining maturity on the original loan. The breakeven interest rate is that which makes the monthly payment on the new equal to the payment on the original loan.

Figures for this table were calculated the same as for previous table.

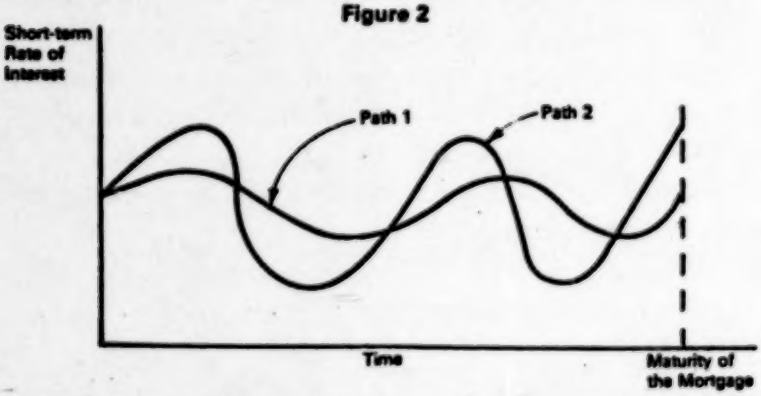
NOTE: Under California law, this table would be relevant only to prepayments made within the first five years of this mortgage. The calculations ignore any incentive to wait for the end of the five-year period when prepayment penalties apply.

The tables present examples based on 30-year mortgages at 10½ percent and 25-year mortgages at 9 percent.

The second simplifying assumption is that lenders demand no premium to accept the risk of insuring consumers against fluctuations in interest rates, or that lenders will be willing to accept additional risk without demanding additional compensation. If lenders demand to be compensated for the role of bearing risk, then they will demand higher prices for fixed-rate loans with increasing expected variability in short-term interest rates over the life of the loan. For example, Figure 2 illustrates two possible future paths

for short-term interest rates which might be anticipated by lenders. These are drawn so that they both have the same average value, but Path 2 exhibits considerably more variability than does Path 1. If lenders expect that short-term interest rates may vary as much as illustrated by the second path they will view fixed-rate contracts as more risky than if they expected the variability illustrated in Path 1. Moreover, if lenders demand a compensation for risk bearing, then the higher variability will mean higher rates for fixed-rate loans.

Figure 2



Finally, the pricing decision will be more complicated if lenders expect that there will be an increasing or decreasing trend in interest rates over the life of the mortgage. If their expectations of interest rates are not the same in each time period or, more precisely, if the expected short-term rate is not independent of time, then the rate charged on the fixed-rate loan will be an average of the rates lenders expect will prevail over the life of the mortgage. If a lender had a perfect knowledge of the interest rate which would exist in each subsequent period, then the interest rate which he would need to charge for a loan of a given maturity would be the geometric average of the one period interest rates incorporated within the maturity. Table VIII shows the three-month treasury bill rate prevailing each January for the years 1967 through 1977. If a lender in 1967 had perfect

knowledge of the interest rate for the next 11 years, and if these interest rates represented the basic cost of his funds, then the interest rate which he would have to have charged for a loan of any maturity in order to cover his basic cost of money could have been determined at the outset. In the example shown, if the loan were to be of a 6-year maturity, the interest rate which would have to have been charged would be 5.44 percent. Charging 5.44 percent for a loan of 6-years maturity would be precisely equal to making six one-year loans at the interest rate shown for the years 1967 through 1972. Similarly, if a lender were to make a loan for the entire 11-year period, the interest rate which he would have to charge to cover the basic cost of his money would be 5.61 percent, plus a premium for risk as discussed above. An important result of this is that if lenders expect rates to be increasing, interest rates will vary directly with the maturity of the loan.

Taken together, these considerations imply that the prices charged by competitive mortgage lenders for fixed-rate loans will be the sum of the following four factors: (1) the average of the short-term costs of funds that are expected to prevail over the life of the mortgage or $E(R_S$, (2) a charge for the operating costs of the lender, (3) a premium for bearing the risk of variability in interest rates, and (4) a premium for the expected losses due to prepayments, L. This can be represented symbolically as:

$$R_L = E(R_S) + P + \quad + L$$

TABLE VIII
Three Month Treasury Bill Rates
for January

Year	*Percent*
1967	4.81
1968	5.09
1969	6.25
1970	8.02
1971	4.86
1972	3.65
1973	5.12
1974	7.42
1975	7.06
1976	5.18
1977	4.33

Source: Salomon Brothers, *An Analytical Record of Yields and Yield Spreads.*

An example will help illustrate the determinants of the price of fixed-rate mortgages. Suppose that over the life of the mortgage, lenders expect their future cost of funds to average eight percent, and that the expected variability of this cost or its variance will be three percent, i.e., it is likely to vary between five percent and 11 percent. Suppose also that in order to be compensated for accepting risk, lenders demand .5 percent on the contract interest rate on mortgages for each percentage point of variance in the future cost of funds. This means that lenders demand 1.5 percent compensation for the assumed risk of future interest rate fluctuations. Next, suppose that after lenders estimate the losses they expect to incur from prepayments they conclude that a .5 percent increase in mortgage rates will be required to offset this loss. Finally, suppose that operating costs represent 1.4 percent, which is close to their recent actual average (see Chapter I). Under these assumptions, lenders would expect to break even if they offered mortgages at a rate of 11.40 percent (8 percent + 1.5 percent + .5 percent + 1.4 percent).

It is important to recognize that this pricing decision is based on forecasts of future events. The actual experience

of a particular savings and loan association or of the savings and loan institutions in a region will depend on the actual cost of funds which materialize over the life of the loan. If costs of funds are below expectations, lenders will make exceptional profits. If actual costs are above expectations, they will incur losses. But the discipline of a competitive financial market will compel lenders to price mortgages so that they expect neither large gains nor losses.

Fixed-rate Loan Prices With and Without the "Due on Sale" Clause

The previous section develops the mortgage lender's pricing decision without explicit consideration of the role of the "due on sale" clause. In this section the effect of the "due on sale" clause is considered.

Prior to dealing specifically with the "due on sale" clause, it is useful to consider the effect of what will be termed a "neutral increase" in the expected maturity of the mortgage. A neutral increase in expected maturity refers to an increase which is not associated with either increasing or decreasing interest rates. That is, the increase in maturity is not due to either falling or rising rates triggering longer maturities.

A neutral increase in expected maturity will have two important effects on the mortgage lender's pricing decision. First, if it is assumed that it is more difficult for lenders to estimate the future cost of funds for periods far in the future than for immediately forthcoming periods, then an increase in the expected maturity will tend to increase the expected variability of interest rates. If lenders demand a premium to bear interest rate risk, this will lead to an increase in mortgage rates. Second, if lenders expect an increasing trend in interest rates (as has recently been the case), this will necessitate an increase in mortgage rates to cover the higher expected cost of funds of the longer maturity. Therefore, under these assumptions a neutral increase in expected maturity will tend to increase mortgage rates.

The elimination of the "due on sale" clause from mortgage contracts has the effect of increasing the expected maturity of loans. But the increase is not neutral in the sense described above. When a lender exercises its "due on sale" clause, except in instances where it is attempting to limit the probability of default, it does so when interest rates are rising. By so doing it limits the losses which will be incurred in its role as the bearer of interest rate risk. It should be noted that restricting the use of the "due on sale" clause has an effect similar to that of making prepayments less costly. The lower the required prepayment charge the less opportunity there is for profit by the lender when interest rates fall. The effect, therefore, of restrictions on the use of the "due on sale" clause is to cause interest rates on fixed-rate mortgages to increase sufficiently to offset the protection previously afforded the lender through his ability to invoke the "due on sale" clause.

This can be illustrated by considering an example of the pattern of anticipated prepayment with and without the "due on sale" clause. There are basically three factors which cause prepayments of mortgage loans prior to their contract maturity; first, prepayment because of decreasing interest rates; second, prepayment demanded by the lender in times of rising interest through enforcement of the "due on sale" clause; third, prepayment induced by high inflation rates in the value of property. This latter type of prepayment may be motivated by a desire to borrow against the increased equity to finance other purchases, or it may be due to the need for a substantially larger mortgage to facilitate resale of the property assuming frictions in the market for second mortgages. If prepayments due to decreasing interest rates are ignored, a hypothetical pattern of prepayments for loans originating in a specific year can be plotted, as in Table

IX.[1] If it is assumed, for example, that loans repaid within the first three years are not caused by inflation-induced increases in the value of property, then these payments will be a result of the exercise of the "due on sale" clauses. Elimination of the "due on sale" clause has the effect of shifting these prepayments into later years when inflation creates a demand for refinancing and thereby increases the average loan maturity.

This effect of the "due on sale" on loan rates can be illustrated using the example presented above. In that instance it was assumed that without a "due on sale" clause the mortgage rate would be determined as follows: eight percent for the expected future cost of funds, 1.5 percent for a risk premium for bearing interest rate risk, .5 percent for expected losses from prepayments, and 1.4 percent for operating costs. Suppose, for example, that lenders assume that with the privilege of access to the "due on sale" clause they can exactly offset the expected losses created by the option to prepay when rates decrease. Also, suppose that the decreased expected maturity reduces the riskiness so that lenders demand .25 percent less in compensation for risk. Given this example, mortgage rates would decrease from 11.4 percent to 10.65 percent due to introduction of the "due on sale" clause.

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[1]Table IX is roughly consistent with recent prepayment experience. See James Boykin and John Phillips, "Implications of the 12-year Prepayment Assumption," *Mortgage Banker*, November, 1976. It should be noted that available data does not permit precise estimates of the portion of prepayments resulting from the three causes discussed here.

TABLE IX
Hypothetical Prepayment Pattern on Mortgages

Years Since Origination	*Percent Prepaid of Loans Originating in Year 0*
1	10
2	10
3	10
4	5
5	5
6	5
7	5
8	10
9	10
10 or more	30

CHAPTER III
THE "DUE ON SALE" CLAUSE IN THE CALIFORNIA COURTS: SUMMARY AND EVALUATION

Introduction

A recent court action in California has made the "due on sale" clause a highly controversial issue in that state. It is the California Supreme Court's decision of August 25, 1978, in the case of *Cynthia J. Wellenkamp v. Bank of America, et al*, in which the Supreme Court decided that the "due on sale" clause in a mortgage loan exercised upon an outright transfer of real property solely for the purpose of adjusting the interest rate on the loan to prevailing market conditions constitutes an "unreasonable restraint on alienation" and, therefore, will not be permitted under California law. The Court limited the potential impact of this decision by ruling that it would have prospective effect only. That is, it held that the decision.

> . . . shall not apply when the lender, prior to the date that this decision becomes final, has either enforced the due-on clause, resulting in sale of the subject property by foreclosure or in discharge of the accelerated

debt, or when the lender has waived enforcement of the due-on clause in return for an agreement with the new buyer modifying the existing financing.[1]

There are three earlier decisions by the California Supreme Court which directly affect the use of the "due on sale" clause. The Court itself has provided a useful summary of its decision in these cases:

> Civil code section 711 sets forth the basic law on the subject and states simply that *"conditions restraining alienation, when repugnant to the interest created, are void."* Our decision in *Coast Bank v. Minderhout* (1964) 61 Cal. 2k 311 recognized that this rule was not absolute in its application, but forebade only *unreasonable* restraints against alienation. In determining whether a due-on clause was unreasonable in *Coast Bank* we looked at whether the restraint was necessary to prevent impairment to the lender's security. We concluded that the restraint was reasonable in that case.
>
> We next had occasion to determine whether a given restraint was unreasonable within the meaning of *Coast Bank* in *La Sala v. American Sav. and Loan Assn.* (1971) 5 Cal. 3d 864. The restraint involved in *La Sala* was a due-on clause which provided for acceleration of the maturity of the loan upon encumbrance of the subject property. In determining whether enforcement of this clause constituted an unreasonable restraint on alienation, we considered not only whether the restraint was necessary to prevent impairment to the lender's security restraint but also the effect that enforcement of the restraint would have on alienation. We concluded that enforcement of a due-on clause upon encumbrance of the subject property involved a significant restraint on alienation such as to preclude enforcement of the clause unless the lender could show that enforcement was reasonably necessary to protect its security. Three

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[1]*Cynthia J. Wellenkamp v. Bank of America et al.*, L.A. 30776 California Superior Court No. 15974, California Supreme Court Decision (Manual, J), page 16.

years later, in *Tucker v. Lassen Sav. and Loan Assn.* (1974) 12 Cal. 3d 629, we confronted the question whether automatic enforcement of a due-on clause upon the sale of the subject property by installment contract constituted an unreasonable restraint against alienation. Examining the principles developed in *La Sala* we recognized that a direct relationship exists between the justification for enforcement of a particular restraint on the one hand, and the *quantum of restraint*, the actual practical effect upon alienation which would result from enforcement, on the other. Thus, the greater the quantum of restraint that results from enforcement of a given clause, the greater must be the justification for that enforcement. Applying this test in *Tucker v. Lassen Sav. and Loan Assn., supra*, 12 Cal. 3d 629, we concluded that enforcement of a due-on clause upon sale of the property by installment contract involved a high quantum of restraint requiring a significant showing that enforcement was necessary to protect the lender's security.[2]

Much of the attention given the "due on sale" clause prior to the Wellenkamp decision dealt with issues surrounding the terms of the sale. Specifically, an important aspect of earlier decisions was the legitimate interest of the lender in guarding against waste or depreciation of the property and preventing default. This became an issue of some complexity because previous cases did not involve an outright sale of the property. However, given the Wellenkamp decision these issues are of substantially lesser importance. In the case of an outright sale, as in the Wellenkamp case, it is much easier to determine whether the lender's security is endangered. Therefore, the Wellenkamp case tended to focus attention on the question of whether the lender's interest in updating the return on outstanding loans is a justification for automatic exercise o the "due on sale" clause.

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[2]*Ibid*, pages 5-7.

The question has arisen whether the recent decisions of the California Supreme Court apply equally to savings and loan associations within the state of California with federal—as opposed to state—charters. On November 1, 1979, the United States District Court of the Central District of California ruled on the issue of federal preemption of state law pertaining to the "due on sale" clause in the case of *Glendale Federal Savings and Loan v. David H. Fox, etc. et al*, and *Federal Home Loan Bank Board (Cross-Claimant) v. Richard T. Silberman*, as Secretary of the Business and Transportation Agency of the State of California (Cross-Claim Defendant). The court defined the central issue of the case as follows:

> The crux of plaintiff's and cross-claimant's argument is that regulation of due-on-sale clauses in the loan instruments of federal savings and loan associations is preempted by federal law, and that defendants therefore may not refuse to issue a public report under the Subdivided Lands Act on the ground that the notes and deeds of trust of Glendale Federal do not comply with provisions of California law governing due-on-sale clauses. Defendants contend that the laws of the State of California pertaining to exercise of the due-on-sale clause apply to federal- as well as state-chartered savings and loan associations located in California.[3]

The Court found that federal law does indeed preempt state regulation of federally-chartered savings and loans. Its statement of the decision is as follows:

> Congress gave the (Federal Home Loan Bank) Board wide discretion to select or reject any state practices as it deemed necessary or desirable in arriving at a uniform federal savings and loan system. Nothing in the (Home Owner's Loan) Act or its legislative history

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[3]*Glendale Federal Savings and Loan Association v David H. Fox, etc., et al*, C V 77-3274-WMB, United States District Court, Central District of California, (Byrne, M) November 1, 1978, page 9.

> suggests the Bank Board was to be bound by or subject to any particular state practice or regulation . . . . The language, history, structure, and purpose of the Home Owner's Loan Act evidence a clear Congressional intent to delegate to the Bank Board complete authority to regulate federal savings and loan associations and to preempt state regulation. Whenever the Bank Board, pursuant to that plenary authority, promulgates a regulation governing an aspect of the operation of federal savings and loan associations, that regulation governs exclusively and preempts any attempt by a state to regulate in that area.[4]

But the U.S. District Court decision is now under appeal by the State of California.

The Supreme Court's Position in Wellenkamp v. Bank of America: Summary and Evaluation

The criterion applied by the Court in the Wellenkamp decision was to compare the "quantum of restraint" imposed by enforcement of the "due on sale" clause with the justification for enforcement. The larger the quantum of restraint, the more substantial must be the justification for enforcement.

The Court held that there was a significant quantum of restraint in that in times of high inflation and interest rates new mortgage loans may not be available or may be extremely costly to the purchasers of homes. Therefore, to deprive sellers of the option to transfer their existing mortgage may preclude the sale of the home. The Court concluded that if the lender is willing to transfer the mortgage, but only at a higher rate, the seller may be damaged in that the value of his equity would decline. The Court stated these arguments as follows:

> The availability of new financing often depends upon general economic conditions. In times of inflation, when money is "tight" and funds available for real

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[4]*Ibid.* pages 12 and 13.

estate loans are in short supply, new financing may be difficult, if not impossible, to obtain. The same result may occur when interest rates and the transactional costs of obtaining new financing are high, making it economically unfeasible for the buyer to acquire a new loan. When economic conditions are such that new financing is either unavailable or economically unfeasible, the seller and buyer will normally agree to a form of financing arrangement wherein the buyer will assume the seller's loan. In such circumstances, if the lender is unwilling to permit assumption of the existing loan, and instead elects to enforce the due-on clause, transfer of the property may be prohibited entirely, because the buyer will be unable to substitute a new loan for the loan being called due, and the seller will not receive an amount from the buyer sufficient to discharge that loan, particularly when the balance due is substantial. (See 1 Miller & Starr, Current Law of Cal. Real Estate, p. 1 (1975 ed.) 3:65, pp. 435-436.) Even when the lender is willing to waive its option to accelerate in return for the assumption of the existing loan at an increased interest rate, an inhibitory effect on transfer may still result. They buyer, faced with the lender's demand for increased interest, may insist that the seller lower the purchase price. The seller would then be forced to choose between lowering the purchase price and absorbing the loss with the resulting reduction in his equity interest, or refusing to go through with the sale at all. In either event, the result in terms of a restraint on alienation is clear.[5]

The Court further held that justification was not substantial, specifically denying that protection of the lender's rate of return on its loan portfolio was a valid justification for

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[5]*Op. cit.*, Wellenkamp, pages 9-10.

exercise of the "due on sale" clause. The Court's opinion is as follows:

> Although we recognize that lenders face increasing costs of doing business and must pay increasing amounts to depositors for the use of their funds in making long-term real estate loans as a result of inflation and a competitive money market, we believe that exercise of the due-on clause to protect against this kind of business risk would not further the purpose for which the due-on clause was legitimately designed, namely to protect against impairment to the lender's security that is shown to result from a transfer of title. Economic risks such as those caused by an inflationary economy are among the general risks inherent in every lending transaction. They are neither unforeseeable nor unforeseen. Lenders who provide funds for longterm real estate loans should and do, as a matter of business necessity, take into account their projections of future economic conditions when they initially determine the rate of payment and the interest on these long-term loans. (See Note, *Judicial Treatment of the Due-On-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability, supra,* 27 Stan. L. Rev. at p. 1117.) Unfortunately, these projections occasionally prove to be inaccurate. We believe, however, that it would be unjust to place the burden of the lender's mistaken economic projections on property owners exercising their right to freely alienate their property through the automatic enforcement of a due-on clause by the lender.[6]

Chapter II provides a basis for a proper economic evaluation of the Court's reason for its decision in the Wellenkamp case. The basic point made in Chapter II is that when

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[6]*Ibid,* pages 13-14.

a fixed-rate mortgage loan is agreed upon the borrower purchases insurance against interest rate risk. The price paid for such insurance and the amount of insurance obtained depend on the terms and the expected maturity of the mortgage contract. When lenders incorporate a "due on sale" clause which they expect can be exercised when property is sold and mortgage rates have risen, they thereby reduce the expected maturity and the expected cost to them of the loan. Moreover, in a competitive mortgage market, prices of fixed-rate loans with the "due on sale" clause will be lower than fixed-rate contracts which do not include the clause. With perfect disclosure of information both parties to the contract should understand that the borrower has the right to a guaranteed interest rate only as long as he owns the property, because this is the nature of the insurance contract he has purchased.

The Court's decision, therefore, raises the question: Who owns the right to the fixed-rate in a mortgage contract when the property is resold? The Court is certainly correct in concluding that higher mortgage interest rates have an "inhibiting" effect on the exchange of property. Moreover, the Court is clearly correct in concluding that in a time of rising mortgage rates, exercise of the "due on sale" clause will make financing more difficult than if it were not exercised. But the Court errs by not recognizing that if mortgage contracts are written and priced with the presumption of exercise of a "due on sale" clause, then the right of access to these advantageous terms of financing has not been sold to the borrower and hence cannot be resold to a new purchaser of the property. It should be apparent that this is not, as the Court asserts, a matter of placing the "burden of the lender's mistaken economic projections on property owners exercising their right to freely alienate their property." On the contrary, to restrict the exercise of the "due on sale" clause

in contracts which have already been written and priced with the presumption of its use is to present a gift to borrowers with existing contracts, not to decrease the equity of homeowners who attempt to sell their property during a time when credit markets are tight. In addition, elimination of the ability to exercise the "due on sale" clause in newly written mortgage contracts will change the assumption under which mortgages are priced. Specifically, state-chartered California savings and loan associations have no choice but to price new fixed-rate mortgage loans on the assumption that, other than in the case of prepayment because of decreasing mortgage rates or due to an inflation-induced demand for larger first mortgages, mortgages will be outstanding until their contract maturity. This makes it inevitable that the effective price of housing would have to increase. Existing property owners who pass on their mortgage terms will demand compensation for doing so. In addition, new mortgages will be priced higher because of the longer average maturities.

It is necessary to emphasize the distinction between elimination of automatic exercise of the "due on sale" clause in existing mortgage contracts and in new mortgage contracts. Prohibition of the use of "due on sale" clause in existing contracts creates a boon for existing borrowers at the expense of lenders. This would seem to be unjustifiable without compensation for the owners of existing savings and loan institutions. Elimination of the "due on sale" clause in new mortgages deprives the marketplace of the use of this option in mortgage contracting. The question which arises is whether the marketplace will be best served by being deprived of this opinion.

There exists at least one legal review of the economic issues involved in the "due on sale" clause which was written after the Tucker decision but before Wellenkamp.

Richard A. Epstein of the University of Chicago Law School has argued that it is inappropriate to view the "due on sale" clause as a restraint on alienation. His argument recognizes the basic economic question of ownership of the right to the fixed interest rate in a mortgage contract:

> . . . the due-on-sale clause has been challenged as an unreasonable restraint on alienation. The concern is, however, quite misplaced, for it fails to distinguish between restraints on alienation that can be ousted by private agreement and those that cannot. In the latter case, the restraint may well have adverse social effects, by preventing the movement of real estate to its highest and best use. A restriction that may be undone, however, serves a quite different function. It only determines the distribution of the purchase price between the bank (as mortgagee) and seller (as mortgagor). The clause shifts to the bank the advantage from the increase in interest rates which would otherwise belong to the seller.[7]

Epstein goes on to point out that an examination of the actual nature of the transaction in the *Tucker v. Lassen* case provides excellent support for his position:

> The first point in the court's argument is that the clause functioned as a restraint on alienation. That view of the situation, however, was belied by the very facts of the case. Before the case had been decided, the three parties involved had provisionally renegotiated the terms of the sale. The buyer received the property as before, although he paid a higher rate of interest to the bank and a smaller sum to the seller. The clause had no effect upon the alienation of the property as such; and indeed the suit was brought by the seller in order

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[7]Richard A. Epstein, "Unconscionability: A Critical Appraisal," *Journal of Law and Economics*, Volume XVIII (2), October 1975, page 312.

to recapture that portion of the price that the clause deflected from him to the bank.[8]

It should be evident from the above discussion that title to the portion of the price in question rightfully belongs to the bank if the seller was a competent party to a mortgage contract which was priced on the presumption that the "due on sale" clause could be exercised.

Epstein raises the interesting and important issue that the "due on sale" clause should be evaluated not as a potential restraint on alienation but within the general context of the criterion of unconscionability. That is, the "due on sale" clause might be challenged in the courts on the basis that it is harsh, unconscionable or unjust. The thrust of Epstein's argument is that while the doctrine of unconscionability is the proper criterion by which the "due on sale" clause should be judged, the "due on sale" clause is not, in fact, unconscionable. Epstein makes a cogent case for not restricting the use of the "due on sale" clause per se. His argument raises an issue which becomes the focus of attention in the Chapter IV. The important question is whether there are practices of mortgage lenders which take unfair advantage of borrowers, and which the "due on sale" clause facilitates. If there are such practices then they might be deemed unconscionable and therefore deserving of restriction. However, to deserve restriction on an economic basis, such practices, if they even potentially exist, must serve no useful economic purpose and must be used principally for exploitation. Furthermore, given that legal restrictions on private contracting are costly to write and enforce, consumers should be protected from such practices only if they are incapable of protecting themselves, presumably due to

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[8] *Ibid*, page 312.

lack of information or sophistication about the terms of their loan contract.

CHAPTER IV
THE ECONOMIC IMPACT OF THE CALIFORNIA SUPREME COURT'S DECISION CONCERNING THE "DUE ON SALE" CLAUSE

Introduction

This chapter examines the impact on both the borrowers and lenders in the mortgage industry of the restrictions on the use of the "due on sale" clause recently mandated by the California Supreme Court. The chapter is divided into two sections. In the first, the impact of restricted use of the "due on sale" clause on lenders, which has been developed in the previous two chapters, is summarized. In the second section, the impact of the Court's decision on mortgage borrowers is considered.

The basic argument presented in this chapter is that restricted use of the "due on sale" clause is in consumers' best interests only if mortgage lenders can use the "due on sale" to exploit consumers. It is argued that, without opportunities for exploitation, use of the "due on sale" clause provides an option in mortgage contracting which consumers value. It is further argued that the only apparent situation where consumers may be at a disadvantage is through the extraction of prepayment penalties and other fixed charges when the "due on sale" clause is exercised. This chapter concludes that if the opportunity for extraction of such fees is properly controlled by legislation, it will be in the best interests of mortgage borrowers to permit unrestricted exercise of the "due on sale" clause.

The Impact of Restricted Use of the "Due on Sale" Clause on Mortgage Lenders

In the previous chapter it was demonstrated that the principal impact on mortgage lenders of restrictions on exercise of the "due on sale" clause results from the fact that the clause is already incorporated in a large number of the outstanding loans of savings and loan associations in California. When these mortgage loans were initiated, the contract interest rate demanded was based on the assumption that the "due on sale" clause could be exercised if mortgage rates increased. This means that lenders were not selling the right to continued access to the fixed-rate in the mortgage contract to new owners of the property. If the terms of the contract are changed, *ex post*, by court or legislative action, such action has the effect of giving borrowers the right to sell to new owners continued access to the fixed-rate mortgage. Because they did not originally purchase this right, there has been created an arbitrary wealth transfer from lenders to *existing* borrowers.

There is also a potential harm to state-chartered California savings and loan institutions if they are deprived of use of the "due on sale" clause in new loans. Lenders would not themselves be directly hurt by being forced to write fixed-rate contracts without the "due on sale" clause if this change in available terms has no effect on loan demand. However, if this contract restriction induces consumers to demand fewer loans or if it is possible for borrowers to shift to other institutions which offer the "due on sale" clause, then there will be a further detrimental effect on California savings and loan associations. Because the restriction on the use of the "due on sale" clause applies only to state-chartered institutions in California (See Chapter III), consumers who prefer fixed-rate loans with the "due on sale" clause will find it advantageous to deal wi h federally-chartered rather

than state-chartered institutions. This penalizes state relative to federally-chartered savings and loan institutions. Moreover, such a substitution may take place because the consumer is likely to perceive fixed-rate loans as being less expensive at federally-chartered institutions due to their use of the "due on sale" clause, but may not fully understand the reason for the difference. Such problems concerning consumer information are discussed in some detail below.

Lenders could be harmed further by the difficulties involved in selling in the secondary market mortgages which do not have the "due on sale" clause. Only mortgages with standardized terms can be sold in the secondary market and the "due on sale" clause is viewed, nationwide, as a standard part of the mortgage contract. This could be a particularly serious problem for California, which is a capital-short part of the country and, therefore, must continually attract capital from other regions to finance mortgages. The difficulties caused by issuance of a non-standard mortgage would not, of course, be limited to the savings and loan associations themselves. Ultimately, any added costs of using a non-standard mortgage would be passed on to the borrower.

The Impact of Restricted Use of the "Due on Sale" Clause on Mortgage Borrowers

If automatic use of the "due on sale" clause is restricted, then the options available to borrowers in choosing mortgage contracts will be similarly restricted. The question at issue is whether or not such restriction is in the borrowers' best interests. The position taken here is that legal restrictions on allowable mortgage contract terms are in the best interests of consumers only if it can be shown that such terms can be used by the lenders to take unfair advantage of the borrowers. Such opportunities, where they exist, usually result

from differences in sophistication and access to information between borrowers and lenders.

In this section, two arguments are made regarding the justification for this contract restriction. The first is that at the equilibrium prices for alternative contracts, consumers apparently prefer fixed-rate contracts with the "due on sale" clause over fixed-rate contracts without this clause. In order to support this argument the relative advantages of the two contracts are compared and consumers' actual choices are examined. The second argument is that the only apparent opportunity to take advantage of unsophisticated borrowers arising from use of the "due on sale" clause is the ability to extract prepayment penalties and other fixed charges when exercising the "due on sale" clause.

In considering whether one would prefer to engage in a mortgage contract with or without a "due on sale" clause it is useful to begin by considering the circumstances under which one would be indifferent regarding the two choices. A reasonable argument can be made that as long as borrowers and lenders have equal access to information and, importantly, that borrowers have no special information about the duration of their ownership of the property, then they won't care whether or not a "due on sale" clause is included in their mortgage contract. Given these assumptions, consumers will be paying a fair price for extra insurance against interest rate risk which is implicit in the contract without the "due on sale" clause. Hence, at that price, they would be indifferent as to its inclusion.

However, the assumption that borrowers have no special information about the duration of their ownership of the property is critical to this argument. The reason is that the "due on sale" clause has the effect of transferring wealth from those property owners who hold their property for relatively short periods of time to those who hold their

property for longer periods. In effect, those people whose time of ownership is less than average subsidize those people whose time of ownership is greater than average. For example, if the average life of mortgages is seven years, then the individual who sells his property after two years has paid for five years of interest rate insurance that he does not use and, because of the "due on sale" clause, cannot resell. The individual who holds his property for 15 years receives eight years of interest rate insurance for which he did not pay. On the other hand, if both individuals had mortgage contracts without the "due on sale" clause they would each pay for a longer period of insurance but would be able to resell any unused portion. Without the "due on sale" clause there would be no wealth transfer based on the duration of property ownership.

If some borrowers in the marketplace expect that they will hold their property for a relatively short time they will avoid mortgage contracts with a "due on sale" clause to avoid the wealth transfer. In the extreme, if all borrowers had a firm notion of how long they would hold their property then all borrowers with expected durations below the average would choose to not use a "due on sale" clause; and, as a result, the expected maturity of loans with a "due on sale" clause would increase. This would stimulate borrowers with even higher expected durations to avoid the "due on sale" clause as the average maturity increased, until the market for mortgage loans with the "due on sale" clause collapsed. Therefore, in order for mortgage lenders to find it feasible to offer mortgage contracts with the "due on sale" clause, there must be a group of consumers which believes their duration of ownership will not be other than the market average. That is, a substantial portion of borrowers must not know that they will own their property for only a short time when they initiate their loan. If this were

not the case, then borrowers would simply choose other types of mortgage instruments.

This argument about consumers' choice of alternative mortgage contracts presumes that lenders would in fact offer alternative contracts if the demand were evident. That is, consumers could not choose whether to utilize a "due on sale" clause if contracts without the "due on sale" clause were never available. This does not require that each lender offer every potential borrower a variety of contracts from which he or she can choose. The costs of offering nonstandard contracts and informing each borrower of the possible options makes this type of flexibility infeasible. What it presumes is that there is a competitive mortgage lending industry so that competing firms which perceive a potential demand will develop a product to satisfy that demand. The highly competitive nature of the mortgage lending industry in California makes it apparent that fixed-rate contracts without the "due on sale" clause have not been offered in that state in recent years because consumers would not be willing to purchase such contracts at the competitive prices lenders would demand for the increased insurance of interest rate risk. This argument is supported by the apparent willingness of lenders to offer contracts for which there is a clear demand at a competitive price for the industry. The recent evolution in California of variable rate mortgages makes it evident that the industry is willing to offer innovative contracts where consumers are willing to pay the competitive price for the contract.

Some might argue, instead, that unless it is possible to cite specific instances where lenders tried to offer fixed-rate mortgages without the "due on sale" clause and found no customers, one cannot conclude that consumers prefer mortgages with the clause. But this argument presumes that savings and loan associations effectively operate as a mo-

nopoly where they find it possible to extract monopoly profits from mortgages with the "due on sale" clause but not from mortgages without the clause. Under this assumption no savings and loan associations would offer contracts without the clause, in spite of a demand for such mortgages. There are two points which suggest that this argument has little relevance for the issue at hand. First, though it is not possible to directly consider the evidence on the state of competition in the California mortgage market here, the market appears to operate in an intensely competitive manner rather than as an effective monopoly. This means that the reason mortgage contracts have not been written at fixed rates without the "due on sale" clause is because, at the market price, there has been no demand. Second, even if collusive behavior could explain the lack of such contracts, the potential for excess profits must lie in the opportunity to extract fixed charges when the "due on sale" clause is exercised. Again, this suggests that the appropriate remedy lies in the imposition of appropriate restrictions on the extraction of such charges, rather than on the forms of contracts which the market is allowed to use.

It is also important to take note of the reasons consumers have given for choosing between fixed-rate and variable-rate mortgages. Survey evidence collected for the Federal Home Loan Bank Board's study, *Alternative Mortgage Instruments*[1] suggests that the major motivation for consumers who choose the VRM over the traditional mortgage is the expected short duration of their ownership. These individuals indicate that they value the assumability feature of the

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[1]Kent Colton, Donald Lessard, David Modest, and Arthur Solomon, "Natural Survey of Borrowers' Housing Characteristics, Attitudes and Preferences," in *Alternative Mortgage Instruments Research Study*, Donald M. Kaplan, ed., Federal Home Loan Bank Board, November, 1977, Volume 1, pp. iii-66.

VRM and do not expect to experience many increases in mortgage rates because of the expected short holding period. Such consumers could always have chosen to purchase a fixed-rate mortgage with long-term insurance of interest rate risk but they would have to pay a price which compensated the lender for bearing the increased risk of interest rate fluctuations.

This analysis indicates that consumers prefer fixed rate-loans with the "due on sale" clause to fixed-rate loans without this clause given the alternative equilibrium prices for these types of contracts. However, it is possible that consumers' choices have been based on imperfect information about the contracts they are choosing. Significant asymmetries in information between borrowers and lenders can create situations where lenders can take advantage of borrowers. There is one compelling argument, however, which suggests that this is not a significant issue regarding the use of the "due on sale" clause in the mortgage industry. Borrowers continue to use fixed-rate mortgages with the "due on sale" clause after having prior experience with it in previous purchases. In fact, the evidence collected for the Federal Home Loan Bank Board's study[2] suggests that some consumers find their experience with fixed-rate contracts to be somewhat more satisfactory than their experience with VRM's, as evidenced by the fact that a sizeable number of borrowers using a VRM indicate they plan to return to the fixed-rate mortgage.

The question which remains is whether it is in consumers' best interests to compel those who would like to obtain a mortgage with a fixed rate to forego the opportunity of

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[2]Gerald Albaum and George Kaufman, "Variable Rate Residential Mortgage: Implications for Borrowers," *Alternative Mortgage Instruments Research Study*, Donald M. Kaplan, ed., Federal Home Loan Bank Board, November 1977, Volume 1, pp. vi-29.

obtaining a contract incorporating a "due on sale" clause. In order to justify restricting consumers' contracting options in such a way it is necessary to demonstrate that lenders can use the "due on sale" clause to take advantage of borrowers' relative lack of financial sophistication. There is a possibility for this kind of exploitation if potentially punitive provisions which are difficult for borrowers to understand can be included in the mortgage contract. Even in a highly competitive mortgage loan market this can be a substantial problem if it is difficult for competing lenders to explain to their potential customers the advantages of contracts which do not include such provisions.

There is one element that can be included in the fixed-rate mortgage contract which fits this characterization quite well. This is the clause which permits extraction of prepayment penalties when loans are prepaid due to exercise of the "due on sale" clause. As developed in Chapter II, the useful purpose served by the prepayment penalty is that it limits the ability of borrowers to prepay loans when mortgage rates decline. As a result it limits the losses to which mortgage lenders are exposed and, therefore, reduces the price of the fixed-rate mortgage. The extraction of prepayment penalties in conjunction with the exercise of the "due on sale" clause serves no such useful purpose. This merely forces an additional payment from the property owner to the lender when the property is resold. Moreover, because the borrower may not fully understand the implications of the payment clause when the mortgage contract is initiated it may be quite difficult for competing lenders to persuade borrowers of the advantages of contracts which do not contain the right to extract prepayments in conjunction with exercise of the "due on sale" clause. Hence, even in a highly competitive market these kinds of provisions may be common. Any legislative action should, therefore, be

directed at the right to demand prepayment penalties or impose other fees when the "due on sale" clause is invoked, rather than at restrictions on the use of the "due on sale" clause.

Notice of Appeal.

Court of Appeal of the State of California, Fourth Appellate District, Division II.

Nini Myrna Tan, et al., Appellants, v. California Federal Savings and Loan Association, et al., Respondents. 4 Civ. No. 23471.

TO APPELLANTS NINI MYRNA TAN AND EUGENIE GOSLING AND THEIR ATTORNEY OF RECORD, FRED CRANE:

PLEASE TAKE NOTICE that respondent California Federal Savings and Loan Association hereby appeals the judgment entered pursuant to the Opinion of this court, filed July 2, 1981 in the above-entitled cause to the United States Supreme Court.

DATED: November 11, 1981

COHEN & ZISKIN
PETER D. COLLISSON
JACOB N. SEGURA
—and—
WILLIAM R. BERRYHILL
By /s/ Peter D. Collisson
Peter D. Collisson
Attorneys for Respondent
CALIFORNIA FEDERAL
SAVINGS AND
LOAN ASSOCIATION

Notice of Appeal.

Court oi Appeal of the State of California, Fourth Appellate District, Division II.

George A. Hanlon, et al., Appellants, v. California Federal Savings and Loan Association, Respondent. 4 Civ. No. 23103.

TO APPELLANTS GEORGE A. HANLON AND JANIS E. HANLON AND THEIR ATTORNEY OF RECORD, FRED CRANE:

PLEASE TAKE NOTICE that respondent California Federal Savings and Loan Association hereby appeals the judgment entered pursuant to the Opinion of this court, filed July 2, 1981 in the above-entitled cause to the United States Supreme Court.

DATED: November 12, 1981

LLOYD F. DUNN, ESQ.
ROBERT JOHN JENSEN, ESQ.
DANIEL S. McDONALD, ESQ.
WILLIAM W. BERRYHILL, ESQ.
WILLIAM L. CALLENDER, ESQ.
JEROME E. TARVER, ESQ.
DONALD PERRY RHOADS, ESQ.

By William R. Berryhill
Attorney for Respondent
CALIFORNIA FEDERAL
SAVINGS AND
LOAN ASSOCIATION

Notice of Appeal.

Court of Appeal of the State of California, Fourth Appellate District, Division II.

John William Ben, et al., Appellants, v. California Federal Savings and Loan Association, Respondent. 4 Civ. No. 23102.

TO APPELLANTS JOHN WILLIAM BEN AND SARAH L. BEN AND THEIR ATTORNEY OF RECORD, FRED CRANE:

PLEASE TAKE NOTICE that respondent California Federal Savings and Loan Association hereby appeals the judgment entered pursuant to the Opinion of this court, filed July 2, 1981 in the above-entitled cause to the United States Supreme Court.

DATED: November 12, 1981

LLOYD F. DUNN, ESQ.
ROBERT JOHN JENSEN, ESQ.
DANIEL S. McDONALD, ESQ.
WILLIAM W. BERRYHILL, ESQ.
WILLIAM L. CALLENDER, ESQ.
JEROME E. TARVER, ESQ.
DONALD PERRY RHOADS, ESQ.

By William R. Berryhill
Attorney for Respondent
CALIFORNIA FEDERAL
SAVINGS AND
LOAN ASSOCIATION

Notice of Appeal.

Court of Appeal of the State of California, Fourth Appellate District, Division II.

William Romagnoli, et al., Appellants, v. California Federal Savings and Loan Association, Respondent. 4 Civ. No 23023.

TO APPELLANTS WILLIAM ROMAGNOLI AND FELICE ROMAGNOLI AND THEIR ATTORNEY OF RECORD, FRED CRANE:

PLEASE TAKE NOTICE that respondent California Federal Savings and Loan Association hereby appeals the judgment entered pursuant to the Opinion of this court, filed July 2, 1981 in the above-entitled cause to the United States Supreme Court.

DATED: November 12, 1981

WILLIAM R. BERRYHILL

By William R. Berryhill
Attorney for Respondent
CALIFORNIA FEDERAL
SAVINGS AND
LOAN ASSOCIATION

Notice of Appeal.

Court of Appeal of the State of California, Fourth Appellate District, Division II.

California Federal Savings and Loan Association, Plaintiff and Respondent, v. H. La Verne Smith, et al., Defendant.

Michael J. Dunn, et al., Cross-Complainants and Appellants, v. California Federal Savings and Loan Association, Cross-Defendant and Respondent. 4 Civ. No. 23201.

TO APPELLANTS MICHAEL J. DUNN AND DIANE R. DUNN AND THEIR ATTORNEY OF RECORD, FRED CRANE:

PLEASE TAKE NOTICE that respondent California Federal Savings and Loan Association hereby appeals the judgment entered pursuant to the Opinion of this court, filed July 2, 1981 in the above-entitled cause to the United States Supreme Court.

DATED: November 12, 1981

LLOYD F. DUNN, ESQ.
ROBERT JOHN JENSEN, ESQ.
HAROLD S. CHARNEY, ESQ.
DANIEL S. McDONALD, ESQ.
WILLIAM W. BERRYHILL, ESQ.
JEROME E. TARVER, ESQ.

By William R. Berryhill
Attorney for Respondent
CALIFORNIA FEDERAL
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LOAN ASSOCIATION

Notice of Appeal.

Court of Appeal of the State of California, Fourth Appellate District, Division II.

William A. Renner, et al., Appellants, v. California Federal Savings and Loan Association, Respondent. 4 Civ. No. 23341.

TO APPELLANTS WILLIAM A. RENNER AND BEVERLY E. RENNER AND THEIR ATTORNEY OF RECORD, FRED CRANE:

PLEASE TAKE NOTICE that respondent California Federal Savings and Loan Association hereby appeals the judgment entered pursuant to the Opinion of this court, filed July 2, 1981 in the above-entitled cause to the United States Supreme Court.

DATED: November 12, 1981

LLOYD F. DUNN, ESQ.
ROBERT JOHN JENSEN, ESQ.
DANIEL S. McDONALD, ESQ.
WILLIAM W. BERRYHILL, ESQ.
WILLIAM L. CALLENDER, ESQ.
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By William R. Berryhill
Attorney for Respondent
CALIFORNIA FEDERAL
SAVINGS AND
LOAN ASSOCIATION

Proof of Service by Mail.

I, Peter D. Collisson, declare:

I am a member of the Bar of the Supreme Court of the United States, and am one of the attorneys for appellant California Federal Savings and Loan Association herein. I am over the age of 18 years and am not a party to any of the within causes. My business address is 2029 Century Park East, Seventeenth Floor, Los Angeles, California 90067. On November 12, 1981 I served a copy of the foregoing Notice of Appeal to the Supreme Court of the United States upon all of the required parties, or to their counsel of record, in said causes by placing a true copy thereof enclosed in a sealed envelope, with postage thereon fully prepaid, in the United States post office mail at Los Angeles, California addressed as follows:

Fred Crane, Esq.
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The Honorable Marcus M. Kaufman
The Honorable F. Douglas McDaniel
The Honorable Margaret J. Morris
Justices of the Court of Appeal,
Fourth Appellate District, Division Two
640 State Building
303 West Third Street
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The Honorable Edward J. Wallin
Orange County Superior Court
700 Civic Center Drive West
Santa Ana, CA 92701

The Honorable J. David Hennigan
Riverside County Superior Court
4050 Main Street
Riverside, CA 92501

The Honorable Robert C. Todd
Orange County Superior Court
700 Civic Center Drive West
Santa Ana, CA 92701

All parties required to be served have been served.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct and was executed this 12th day of November, 1981 at Los Angeles, California.

/s/ Peter D. Collisson
Peter D. Collisson